

FINANCIAL GLOBALIZATION AND THE EMERGING ECONOMIES

Editors

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FOREWORD

Financial globalization has been a most dynamic component of the continued globalization experienced by the world in recent years. Capital flows to a large number of emerging economies expanded rapidly during the 1990s. Such capital surges were often followed by financial crisis affecting several emerging economies of Asia and Latin America in the 1990s.

There is a broad recognition that financial instability is deeply rooted in the present operation of markets, which has brought consensus on the need to examine the issue in depth, in order to urgently find better solutions for crises prevention and crises management. The meetings of International Financial Institutions, G-7 and various groupings of developing economies have directed their attention to this issue.

This collection of essays results from an international conference convened by ECLAC and the International Jacques Maritain Institute of Rome in Santiago de Chile in 1999. This conference brought together policy-makers, academics, members of international institutions (BIS, EBRD, IMF, OECD), and social actors (mass media, labour unions, churches and financial activity).

The book includes four parts. The Introduction collects the opening statements in the conference. Part I contains a discussion of the issues and proposals on how to reform the international financial structure. Part II discusses the national policies to face financial instability, and their role in stabilizing capital flows. Part III includes statements by different social actors on their views on financial globalization and their messages to policy-makers.

Santiago, Chile, January 2000

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INTRODUCTION

1. INTERNATIONAL FINANCE: FACTOR OF PEACE OR OF CONFLICT?

*Roberto Papini**

First of all I should like to give my heartfelt thanks to all those who have helped to make this seminar possible. Their intellectual contributions, organisational skills and financial support have all been invaluable. In particular, I should like to thank Dr. Eduardo Frei Ruiz-Tagle, who wished to stress the importance of this meeting by opening it himself in the Presidential Palace. My special thanks also go to ECLAC, with whom we have organized the seminar, and to the Financial Observatory of Geneva for its technical advice.

I must also thank all of you who have come to Santiago, especially those who have had to face a long journey, to take part in a pluralist debate on what is probably the most complex element in the globalization that the world is now experiencing: the financial market and its effects on the emerging countries. First of all, its effects in Latin America, where the crisis of the Brazilian currency, after those of Southeast Asia and then Russia, and their social impact, are causing the greatest concern, in the sub-continent and beyond.

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This seminar is part of a research project on globalization and peace that the Maritain Institute has been working on for a number of years. The project consists of an analysis of the globalization model that is being imposed on the world, in order to evaluate its effects on development and social justice -does it foster these (and consequently peace) or does it act against them? In particular, we hope to identify the structural traits that cause instability in the system that is emerging, their impact on cultures, society and politics -are they helping to create one world for everyone, or are they causing fragmentation?

We believe that our Institute is well qualified to examine this problem, which will certainly be one of the most vital for the next century. Jacques Maritain himself, one of the fathers of the Universal Declaration of Human Rights, was convinced that pluralism would be essential in the global village. Long before our current debates on globalization, at the end of the 1940s, in *Man and the State*, he had already launched the idea of a world authority as a means of promoting peace, stressing the need to rethink, socially and morally, the way we live together on our planet.

The first stage of the project closed with the seminar held in Milan from 29 to 31 October 1998 on "Globalization: a challenge for peace. Solidarity or exclusion?", in which representatives of the major international bodies exchanged views with representatives of governments and civil society. Two things in particular emerged from these debates: first, there is less optimism about the processes under way today than there was before the recent financial crisis, and, secondly, greater determination must be shown over the need to create a new, more rational, architecture for the international organizations.

The subject of the second stage of the project, "The globalization of the financial markets and its effects on the emerging countries", culminates here in Santiago, in a country that is often held up as a model for development, attempting to unite efficiency with fairness through a system for controlling capital movements that seems to work well. We have invited not only insiders, experts and politicians, but also outsiders, from various fields of civil society.

The next appointment will be in Israel, where we shall discuss "Globalization, religions and cultures", and the last will be in Rome, where the subject will be "Globalization and the new international order".

A glance at what has been written over the last three years about the recurrent international financial crises shows clearly the tone of the debate on globalization. The press, the academic world and governments all appear to be absolutely convinced that globalization is, on the whole, positive, increasing the volume of trade, raising the income of both industrialized developing countries and helping to improve living standards in most of the

areas that are integrated in the process. Few voices, sporadic and faint, have expressed doubts or reservations, and the strong dissent of some more radical sectors is still simply dismissed as futile resistance to an unstoppable trend.

In spite of the signs of crisis, the international actors continue to believe that in the end the market will be able to correct its own excesses, even going as far as to embrace the thesis of the 'new paradigm'. Spurred on by this trust, the theory is widespread today that growth occurs through longer and longer economic cycles and higher and higher rates of development, with low inflation and increased productivity, thanks to the greater efficiency deriving from new technologies. The recurrent financial crises, with all the human and political tragedies they bring in their wake, are still viewed as inevitable incidents on the road to an economic Eldorado. For some time, though, even the IMF and the World Bank have been admitting that a good few of their interventions in support of emerging countries in crisis were too drastic, that the medicines they prescribed have had disastrous side effects and have proved toxic. In short, they prescribed overdoses. The international financial institutions cannot be blamed for the inter-ethnic and inter-religious guerrilla warfare that appears to be leading Indonesia to geographical and political disintegration, but they do bear some responsibility for the situation, if only indirectly. The Asian conglomerates and the western multinationals are certainly not to blame for Russia's inability to stabilize its economy, but the programme of fiscal austerity proposed by the creditors of the ex-Soviet Union was obviously a very risky medicine to prescribe. The international financial institutions are not solely to blame for the recent events in Ecuador but, once again, their actions have not been notable for their long-sightedness.

All the analysts agree that it is finance that moves the real economies and not vice versa. Over the last 10 years, paper transactions have been 12 times the global volume of trade in material goods, and the developed countries of the western world have had by far the biggest slices of this enormous cake. There was no political plea-bargaining and no hesitation about saving Long Term Capital Management (LTCM), the American merchant bank, from bankruptcy -money was taken in fistfuls from the 'lenders of last resort' funds and the Central Bank in Washington, with no concession to austerity and free market principles. Even the most strenuous advocates of *laissez-faire* economics are ready to yield to the temptation of government intervention when it is their own house that needs to be repaired.

Little wonder, then, if in Asia, in Russia, in Latin America and in the Middle East, faith in the last instance creditors -i.e. the international institutions that ought to rush to the rescue before the ship sinks to the bottom- is wilting and giving way to diffidence, if not disheartenment.

More and more, people are coming to believe that the recurrent crises could be avoided. More and more, they suspect that their main effect is to

make the advanced countries even stronger. And the reason, though partly political, is first of all structural, for only the advanced countries have been able to increase their productivity through massive investments in new technologies. Often the only way the second or third countries –Asian, Latin American and even many European ones– can withstand the shock wave of hyper-competition is by massive restructuring, which destroys their social capital and reduces their share of wealth. Obviously the new opportunities that the system creates must not be neglected, but it is only fair to ask whether, on many occasions, a further structural obstacle to the development of these countries is not being created, making them more fragile and vulnerable, still more dependent on the industrialized countries.

Whatever judgement may eventually be passed on the latest events, that given in 1998 by Michel Camdessus, Director General of the IMF, is certainly worth quoting: “Alors que, dans chacun de nos pays, nous avons mis parfois jusqu’à cent ans pour mettre en place des institutions permettant le fonctionnement des marchés financiers, au niveau mondial, on a laissé se développer le marché des capitaux dans l’anarchie la plus complète. Nous entrons dans le XXIème siècle, celui de Bill Gates et George Soros, avec un marché régi comme au temps de Balzac. Il est urgent de remettre les pendules à l’heure. C’est l’objectif de nos travaux sur l’architecture d’un nouveau système financier mondial”.

“A rising tide lifts all the boats.” This aphorism sums up the general thinking underlying the current model of globalization, where the main objective is economic growth, presumed to be the basis for achieving every other goal. The decision-making power of governments is consequently placed at the service of the quest for the maximum economic efficiency, and as this efficiency is measured against a global market whose strength has become absolutely decisive, political power –the democratic choice of a country’s citizens– is becoming more and more marginal.

In Europe, the cultural matrix of Socialism and that of Christianity both based their social architecture on a form of solidarity that it was the duty of civil society and democratic politics to pursue. The dignity of the person and a fair distribution of income were no less important than economic efficiency. The globalization of the financial markets, however, with its frenetic pursuit of profit, is distancing us further and further from the “European social model”-although it was not just European- forcing on us other priorities, if not, indeed, other ends.

It is because of this clash of cultures, as well as the events of the last three years, that we must think deeply about what kind of governance should be created and what its aims should be. To what extent can globalization be made sustainable, responding to the needs of the peoples of the world and to the

equilibrium of the world itself? To what extent can globalization be governed democratically?

A system of democratic governance of globalization must be created, and this will entail reform of the international political and economic institutions. To achieve this, the key resources will be a transnational civil society and transnational public opinion, both of which must be cultivated assiduously to ensure their healthy growth. It is these that form the true 'political body', the guarantor of ethical standards in public institutions and democracy at both regional and world levels. After all, history teaches us that this has been the path followed inside nations states in order to reach the goal of full democracy.

The goals facing us now are to ensure that the resources of our planet are shared fairly among all its people and to reconcile the universality of human rights with the cultural identities of different peoples. To achieve this, we must give a bigger voice and more power to the intermediate transnational bodies –not just to the economic and financial multinationals– if we are to have a new political architecture that is not simply a superstructure. Perhaps the time has come to propose the right of mankind to democratic governance. Only an increasingly active awareness of this right will transform the 'necessity' of globalization into the virtue of liberty.

2. WHERE DO WE STAND?

*José Antonio Ocampo**

Financial instability has been the most striking characteristic of the functioning of the world economy in recent years. The worldwide financial crisis that began in Asia a year and a half ago took on a more dramatic cast following Russia's declaration of a moratorium in August 1998 and then swiftly spread to Latin America. The Brazilian crisis of January 1999 was the third chapter in this suspense story. Although the return of some Latin American countries to the market since March indicates that they made a faster comeback than they did after the disturbances of October 1997 and August 1998, thereby providing grounds for a moderate degree of optimism, market conditions were not normalized: borrowing costs remained high, maturities short and credit in short supply. There will be further bouts of financial instability in the future, just as there were before the Asian crisis, such as the European monetary crisis of 1992 and the 'tequila' crisis of 1994.

'Volatility' and 'contagion' became the favourite terms of analysts seeking to describe the two pivotal aspects of the financial market's behaviour during the recent crisis. The first refers to the financial market's tendency to go through boom-bust cycles in which capital flows first grow and then contract more than what economic fundamentals would recommend. The second term

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alludes to the market's inability to distinguish properly between one type of borrower and another. Although this trait has been discussed a great deal in terms of the role it plays in financial crashes, it is just as much a factor during economic booms. Nonetheless, its devastating effects during times of crisis are, of course, the most pathological manifestation of a malfunctioning market, as is attested to by the long list of financial crises experienced by both developed and developing countries alike.

In order to manage the instability of financial markets, complex networks of institutions have been set up at the national level, primarily since the 1930s. These institutions have served both as preventive mechanisms and as effective instruments for averting the destabilizing effects of financial crises. This 'financial safety net', as it is also called, encompasses the functions performed by the central bank as a lender of last resort, financial regulation and oversight, mechanisms for State intervention to prevent a disorderly collapse of financial intermediaries during crises, deposit and credit insurance and guarantee systems and suitable bankruptcy procedures for dealing with debt overhangs of non-financial economic agents. This safety net does not always succeed in warding off impending financial crises altogether, as is demonstrated by the various episodes of this kind that have occurred even in the industrialized countries, but it has clearly forestalled the most chaotic manifestations of the financial crashes that overtook many countries until the 1930s.

There is a growing consensus that the ever-more frequent international financial crises sweeping over the world in recent decades attest to the absence of a similar process of institution-building at the global level. There is, in other words, a growing conviction that the frequency and magnitude of these disturbances are a reflection of the tremendous asymmetry existing between an increasingly sophisticated, yet unstable, international financial market and the institutions that regulate it. In short, the world lacks the institutions that financial globalization requires.

There is an increasing awareness of this fact at the international level, where the discussion of these issues has given rise to a consensus on a number of issues. These areas of agreement are reflected in the statements issued by the Group of Seven (G-7), the Heads of State and Government of several regions in the developing world, the International Monetary Fund (IMF) and other international organizations, including a document drafted in early 1999 by the economic and social agencies of the United Nations in whose preparation ECLAC played an important role. There is consensus as to the need for the industrialized countries to maintain expansionary policies so long as the present financial uncertainty persists and for contingency financing to be made available to buttress troubled economies before –rather than after– their international reserves reach critically low levels.

There is also a basic agreement as to the wisdom of improving the flow of information, developing international codes of conduct in various areas and upgrading prudential regulation and supervision at the global level –i.e. improving the institutional framework in which financial markets operate. There are still, however, many differences of opinion as to which institutions should be entrusted with responsibility at the international level in these areas. A consensus also exists as to the need for more effective oversight of all countries' macroeconomic policies, especially during the bouts of financial euphoria that engender such crises, and for a means of ensuring that the industrialized countries' macroeconomic policies will be consistent with the goal of stable, non-inflationary growth for the world economy.

Just as importantly, today it is widely recognized that programmes aimed at liberalizing the capital account must be properly sequenced and must be implemented cautiously, especially in the case of short-term flows. There is also an awareness that strong prudential regulation and oversight mechanisms at the national level are a prerequisite for any such process and that any international rules instituted in this sphere must include safeguards for coping with difficult circumstances as they arise. The international community has also recognized the need to establish orderly debt workout mechanisms to deal with critical external debt problems and to ensure that the private sector bears an equitable share of the burden of adjustment. And, finally, there is also a broad consensus as to the need to strengthen our social safety nets to protect the vulnerable groups in society from the harmful effects of adjustment processes.

Alongside these important areas of consensus, however, there are many differences of opinion, some of which are of vital concern to the developing countries. I would like to refer briefly to six of them here. The first and foremost of these issues is the financing of *contingency mechanisms*. The periodic contributions made by industrialized nations to IMF or for specific emergency loans have proven to be a highly unreliable funding mechanism. Under these circumstances, it is clear that we need to design much more dependable instruments to respond rapidly to the demand for additional liquidity in times of crisis. The active use of special drawing rights (SDRs) for this purpose would surely be the best way of doing so. The creation of SDRs during periods of crisis could even be coupled with a mechanism allowing for their automatic elimination during subsequent periods of recovery, thereby introducing a counter-cyclical component into international liquidity management. In fact, and this is my second point, the *active use of SDRs* in international finance is of the utmost importance to developing countries. The current state of affairs should therefore serve to restore this instrument to the central role that it should play in the international financial order.

The third issue is the most controversial of all. Outside of an influential circle, there is an increasingly widespread perception that the conditionality applied by the IMF is being carried beyond what may actually be necessary in order for the Fund to perform its functions properly. It has, in particular, been extended to include questions relating to economic and social development institutions and strategies, which fall within the purview of other international organizations and especially of legitimate national authorities, and which should be founded upon broad-based social pacts. Thus, the current discussion should also help us to arrive at a new agreement as to the *limits of that conditionality* which will, in turn, ensure its continued legitimacy.

Before going on to the last three points, I would like to take a moment to discuss the implications of what I have just said in terms of the role of the IMF. The active role played by this instrument of international cooperation in funding emergency loans and channelling them to emerging economies during the crises they have experienced in the course of the 1990s has, in our view, helped to stabilize financial markets. We count ourselves among those who believe that we need a strong Fund equipped with effective financing mechanisms, and we believe that the effort it devotes to surveilling macroeconomic policy and monitoring the development of financial markets should be intensified so that it can play a more assertive role in crisis prevention in the future. But we also believe that the greater power which this would give it, and which we hope the international community will grant it, should be accompanied not only by greater transparency and accountability for its actions, as the Fund itself has recognized, but also by efforts to arrive at a broad-based consensus concerning the conditionality of IMF lending. Moreover, we believe that the failure to reach such a consensus may ultimately undermine the Fund's very foundations.

The fourth point I would like to make is that, so long as we lack an adequate order and, most importantly, a suitable regulatory system at the international level to prevent crises from occurring, together with clear-cut rules regarding access to appropriate amounts of contingency financing, the developing countries should, in our view, maintain the autonomy to *manage their capital accounts*. A fifth is a related point on policy autonomy. In recent years, some authors have argued forcefully that the only stable exchange rate regimes in the current globalized world are either a convertibility scheme or a totally free exchange rate. However, owing to inherent deficiencies of both extremes, authorities tend to choose in practice intermediate regimes. In this context, it would be inappropriate to determine any sort of conditionality in this area. Thus, countries should continue to be *free to choose the exchange rate regime* that they find preferable.

The sixth point I would like to make is that the present situation provides an invaluable opportunity for re-thinking the role of *regional and subregional*

financial institutions. We are convinced that an international financial order that is based on a network of regional and subregional reserve funds and development banks, rather than on a few international organizations, will contribute not only to the stability of the world economy but also to more equitable conditions at the global level. Latin America and the Caribbean should therefore work to strengthen existing agencies and to complement them with new regional and subregional mechanisms of financial cooperation.

The crisis has made it clear that the developing world remains highly vulnerable to external financial cycles. Obviously, this also underscores the need for appropriate domestic mechanisms for managing these cycles successfully. I would, therefore, like to conclude by pointing out a quite simple yet vital fact which ECLAC has emphasized in the studies it has prepared in the course of this crisis: the need to shift the focus of attention of the authorities away from managing the crisis and towards managing booms, since crises are, in most cases, the inevitable outcome of poorly managed economic booms. This tenet which, as we have noted, clearly applies to international institutions, is equally valid within the realm of domestic policy.

In fact, an excessive concern with crisis management may cause us to overlook what ought to be an obvious fact: that the degrees of freedom available to national authorities are greater during booms than during crises. An economic boom involving excessive increases in public and private expenditure will inevitably give way to an adjustment whose severity will be proportional to the extent of over-spending which preceded it. Thus, an unsustainable increase in public spending based on transitory tax revenues and special external credit facilities will bring a severe adjustment in its wake. Excessive borrowing by the private sector based on an underestimation of its exposure will lead to a severe credit squeeze later on; this is usually accompanied by a deterioration in bank portfolios which, if it is serious enough, may generate losses equivalent to several percentage points of GDP. By the same token, an overvaluation of the currency based on transitory capital inflows or extraordinarily high export prices will exert a great deal of pressure on the exchange rate or on interest rates once these temporary flows have evaporated.

Given this state of affairs, the fundamental challenge in managing external vulnerability is to design appropriate tools for handling economic booms. These tools should include, first of all, mechanisms for sterilizing transitory tax revenues. The limited experience that has been gained in the use of stabilization funds to manage government revenues from commodity exports should be extended to include the management of transitory tax revenues. This also suggests that rather than setting fiscal targets on the basis

of the current fiscal deficit, these targets should be set on the basis of the structural deficit, as is done in the OECD countries. Many countries may also find it advisable to counter-balance short-term trends in private spending, either entirely or partially, with opposing movements in public expenditure, which would, incidentally, also allow public sector borrowing to offset borrowing trends in the private sector. Experience shows us, moreover, that a public debt profile that includes too large a component of short-term credits may be manageable during times of prosperity but may have much the same sort of destabilizing effect on financial markets during times of crisis as an unsuitable external debt maturity profile has, a point on which there is now widespread agreement.

On the monetary and exchange rate fronts, the establishment of reserve requirements on foreign currency deposits, a system being used successfully by Chile and Colombia, fulfils the dual purpose of creating appropriate incentives for the maintenance of a suitable maturity profile for external liabilities and of moderating the exchange rate and monetary pressures generated during economic booms. Within certain limits, sterilizing the monetary effects of increases in reserves has proven to be a useful practice in many countries. The system designed by Argentina of discouraging short-term financial deposits by setting higher liquidity requirements for them than for long-term funds has also proven to be effective.

Finally, as has been said so many times before, a strict form of prudential regulation of the financial system is vital in order to prevent intermediaries from assuming unmanageable levels of risk during times of abundance. Prudential regulations should clearly take into account the links between domestic financial risks and changes in key policy instruments, notably exchange and interest rates. This indicates that these regulations should be stricter in developing countries, where such links are more important, and that they should be strengthened in periods of financial euphoria to take into account the increasing risks which financial agents are incurring. A crucial policy in this area might be to expressly regulate the percentage of the value of financial and real estate assets that can be used as collateral during boom periods.

The crisis has given us the opportunity to re-think the entire world financial order and to use that collective analysis as a basis for more effective and more balanced forms of international cooperation. In closing, let me emphasize the importance of maintaining a free-flowing dialogue between developed and developing countries. This type of dialogue should serve as the source of inputs for broad-based negotiations, in the appropriate forums, in which the developing countries are properly represented. This is the only way to bring about the reforms which the developing world is entitled to demand to ensure a more appropriate international financial order.

3. GLOBALIZATION AS AN ECONOMIC AND SOCIAL FORCE: OPPORTUNITIES AND RISKS FROM A HUMANISTIC PERSPECTIVE

*Eduardo Aninat**

The Jacques Maritain Institute and ECLAC –with the sponsorship of the Chilean government through the Ministry of Finance– have organized this noteworthy international seminar in which I have the honour of participating. My focus, looking ahead to the session dealing with the impact of globalization on development strategy in emerging countries (Part I of this volume), will be to speak to and analyze the question of governance in the context of financial globalization I will take the opportunity to voice some observations about where we are with regard to governance, about the main features of recent developments in the international economy and their effects on emerging countries and also to offer some observations about globalization and social values.

The idea of reforming the international monetary system has found support in the notion of the need to minimize the effects of the phenomena that have attracted the world's attention in the recent crisis –namely, the shocks created in receiving countries by the volatility of capital flows and the

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shocks created by the bandwagon effect, which draws country after country into the syndrome. Consideration of the volatility of capital has focused specifically on the exacerbation of the flight of capital from countries that are in crisis.

International consensus was achieved quickly on the need to supplement the Basle standards with the IMF Supplemental Reserve facility (window) and the IMF Special Data Dissemination Standard (SDDS), and in recent discussions on designing a possible contingent credit line for a selected group of emerging economies with medium- and long-term solvency. Progress is being made in improving the quality of information and in strengthening banking and financial systems, as well as through other measures aimed at improving the resistance of emerging economies to shocks like these. Changes have been suggested in financial action taken by both lending countries and multilateral institutions. Though it is accepted that such measures cannot eliminate volatility and contagion, there is hope that the negative impact of these problems can be reduced.

Some leading players believe that with these measures in place, drastic reform of the international monetary system is unnecessary. They argue that since prices of assets will always be volatile, crises will continue to arise, and that therefore it is the emerging countries that should implement new reforms and bring their financial systems to function in a better way.

There is no denying that many countries that are in the process of integration in the international economy are in need of reform. However, it seems to me that underplaying the need for a penetrating analysis of today's international monetary system is a mistake. No one who has been an observer or participant in the recent developments in the world economy can fail to see the important role that the volatility of international reserve currencies and interest rates in developing countries has played for the debt-acquisition dynamic in many developing economies -not only in the current crisis, but also in the debt crisis of the early 1980s. Indeed, some maintain, and not without justification, that today's volatility dates from the collapse of the Bretton Woods system. Are we to think that periods of prolonged and very significant appreciation of the dollar, followed by the depreciation of this reserve currency, have not influenced the debt dynamic in developing countries?

Because these periods coincided with massive fluctuations in international interest rates, the situation was aggravated in the 1980s. This meant, to simplify somewhat, that many countries borrowed 'cheap dollars' at very low interest rates and were forced to service their debt with 'expensive dollars' at interest rates several times higher.

We consider the major advantage of the present system of flexible exchange rates to be that it makes great worldwide capital mobility possible without requiring that national monetary policy be sacrificed. This very advantage may, however, turn out to be the system's greatest drawback, as it entails accepting the potential effects of excessive volatility in the prices of international reserve currencies.

Let us recall that the main problem confronting the architects of Bretton Woods was to re-establish trade and international relations, which had not been normalized in the wake of the First World War. Given that priority, it was deemed necessary to give up an emphasis on increasing the mobility of private capital for the sake of preventing volatility. Furthermore, under the gold standard, capital flows and exchange rate stability had priority. Hence, the independence of national monetary policies was sacrificed. This leads me to believe that in today's world of advanced financial globalization, great care must be devoted to examining these subjects. A serious intellectual effort is needed to clarify the central points, in order to determine what decisions must be made about the international monetary system, what framework is to be employed, and what reasonable transitions are to be provided.

1. Recent developments in the world economy

I would like now to say a few words about developments in the international economy that began in 1997. The international tumult that began then has forcibly reminded us of certain old lessons, as well as presenting some new scenarios. I will take the liberty, in dealing with these matters, of mentioning some aspects of Chile's experience in the crisis.

A first lesson is that debt can be risky, and that short-term debt in particular is dangerous if it reaches high levels. The countries that suffered the greatest turbulence in the last two years are those that had reached high levels of short-term debt before the crisis began –and this observation is true regardless of whether debt was public or private. The policy of the Chilean government was to use a portion of the country's budget surplus to reduce public sector foreign debt year by year, making early payments of principal owed to the multilateral organizations, which, in the short period from 1995 to 1997 had reached US\$ 2.2 billion. The 'fat' period was thus taken advantage of by being prudent and by exercising a great deal of caution in managing the public debt. Short-term private debt, in turn, was discouraged by the reserve requirements of the Central Bank of Chile. As a result, private sector debt at this juncture is primarily long-term.

A second, eminently classic, lesson is that sound fiscal management (handling of public finance) is a prerequisite for the attainment of a solid

response capacity to external shocks. Fiscal soundness does not totally compensate for situations of excessive spending by the private sector in boom conditions, but it does provide some necessary counterbalance. Chile has achieved budget surpluses on the order of 1.5% and 0.4% of gross domestic product ¹ in recent years. The public sector has thus, by virtue of great budgetary prudence, contributed to giving the Chilean economy greater resistance and strength with which to face externally generated turbulence.

The conditions that makes it possible to employ well designed economic policy and deal successfully with externally generated shocks are familiar. Among them are the absence of major macroeconomic distortions, the presence of structural reforms to improve the functioning of price systems and market efficiency, orderly and well coordinated monetary and fiscal policy, properly regulated national financial sectors and reasonable levels of debt with optimized maturities. On the other hand, accumulated imbalances and distortions make economies vulnerable not only to attacks of speculation, but also to sudden and large reversals in capital flow, which amplify the magnitude and severity of crises. The old question of reversals of flow and impact of flight capital comes into play here.

Relative to other economies, Chile has suffered relatively little from the effects of volatility. Its structural underpinnings have allowed long-term capital to continue flowing into the country, while top private sector Chilean corporations have continued to obtain considerably narrower interest rate spreads than those available to the governments of many countries.

2. Globalization and social values: concluding thoughts

Globalization manifests itself at the national level in many ways. It affects the strength, structure and vulnerability of the economy, the distribution of opportunities and income, the arts, culture, forms of participation in national life and solidarity and commitment among citizens. It is undeniable, in any case, that globalization is making us increasingly integral parts of the world economy, and that we interact more and more with institutions and individuals from a range of countries. There can be no doubt of the many benefits that this process brings. We cannot, however, ignore its impact and consequences for those groups that are vulnerable –in developed as well as developing countries.

For many workers, even those with average wages in industrial countries, globalization has led to unemployment as businesses have moved production

¹ Logically enough, with a significant downward trend in 1998 GDP, for obvious anti-cyclical reasons.

to countries where costs are lower. This entails a shift in national advantages among countries, a phenomenon which in many places may have social implications.

There is a growing effort to codify and harmonize international economic relations. The World Trade Organization (WTO) has become stronger as a forum for arbitration of disputes –a welcome development from the point of view of smaller countries.

Domestic business decisions are increasingly made with the world economy in mind. Alternatives for expansion and location of new production activities have multiplied. Investment and production decisions have, in a sense, been ‘de-nationalized’. The debate on the role of the State would seem to indicate agreement on the notion that that in lieu of protections, privileges and subsidies for the private sector, clear rules, as firm and stable as possible, should be put in place and made known to both foreigners and nationals.

Increasing specialization and the characteristics needed to compete in the market today require more highly skilled and flexible labour. Job stability has diminished, and the differences between skilled and unskilled workers have become accentuated throughout the world. Unless the State is able to implement effective policies of redistribution and human development that go beyond traditional measures, inequalities will tend to worsen. This would work against the achievement of a minimum level of social justice and would jeopardize the political stability of many countries.

The intensification of competition, efficiency requirements and the need for strict financial management, an emphasis on short-term results, and the existence of many activities that depend on world markets all are detrimental forces as far as solidarity is concerned. They weaken roots and national identity, a phenomenon with consequences for social values that demands serious attention. In short, political leaders and parties in the underdeveloped world face a true dilemma. On the one hand, globalization brings undeniable material benefits, increases access to information and knowledge, broadens investment opportunities and is a process difficult to control. On the other hand, it has unsatisfactory results for society’s most vulnerable groups, bringing increased inequality and uncertainty, and there is potential danger of social disintegration and loss of national identity.

The development of each and every one of a nation’s citizens in all dimensions –spiritual, cultural, social and political– is a paramount objective. National identity and solidarity are an essential part of this undertaking, and a central component will be to actively promote opportunities for advancement in employment, training and human development for society’s most vulnerable groups and sectors.

The new challenge, then, is to bring together a humanistic vision, in which the human being is the centre of concern, with the globalization process and a model of world growth that provides for the continuation of the liberalization process in order to achieve a rapid expansion of production. The aim here is to create new job opportunities, which are essential to the maintenance of human dignity, and to generate the public resources needed for education, health and poverty-reduction programmes.

The task is clearly enormous. But it represents a challenge brimming with opportunities and offering fertile soil for the thinkers of the new global era that is upon us.

4. FINANCIAL MARKETS AND GLOBALIZATION: THE PERSPECTIVE OF EMERGING ECONOMIES

*Eduardo Frei Ruiz-Tagle **

ECLAC and the International Jacques Maritain Institute have invited us to discuss the globalization of financial markets and its effects on emerging economies. This phenomenon has been of concern to vast sectors of our societies for quite some time now, especially in view of the turn taken by international economic and financial events in recent years.

Finance has been at the heart of many economic crises that have taken on international proportions. The financial dimension played a central role in the depression of the 1930s and in the debt crisis that overwhelmed a number of developing countries in the late 1970s and early 1980s. In the 1990s, this dimension has also had a profound influence on the Mexican currency crisis that broke out in late 1994 and the current crisis that began in Asia. Recent crises have borne witness to the serious imperfections of the international capital market and the developing economies' extreme vulnerability to disturbances emanating from that market.

When the Russian moratorium was declared in mid-1998, the international financial crisis began to take on alarming proportions as its effects spread to the stock markets of industrialized and emerging economies alike and came to pose a serious threat of global deflation and recession. The measures that have had to be adopted to deal with this situation have been

* Former President of Chile.

much harsher than would be justifiable from the standpoint of any individual economy, because they must address speculative pressures that are external in origin. This type of financial contagion has thus had a heavy cost for the Latin American countries, a cost that is not justified from a domestic perspective and is therefore economically and socially inefficient.

But above and beyond the specific macroeconomic situation of any individual Asian or Latin American country that has been hurt by this instability it is, as ECLAC has emphasized, first and foremost a reflection of a fundamental problem in the global economy. That problem is the enormous asymmetry existing between an increasingly sophisticated, dynamic international financial market and the absence of a suitable institutional structure for regulating it.

The tools currently at our disposal for coping with these serious imperfections have proven to be entirely inadequate. On the one hand, the adjustment programmes instituted by countries overtaken by such crises have once again demonstrated that we tend to seriously underestimate their recessionary impact; what is more, each such programme has introduced additional deflationary pressures into the world economy. This strong recessionary impact has, in a number of cases, prevented the achievement of one of the prime objectives of the adjustment process –namely, the restoration of investors' confidence that the economy is functioning properly.

On the other hand, in the case of emerging markets as well, in recent years rating agencies –the institutions chiefly responsible for providing information to investors– have proven to be an unsatisfactory tool. Their behaviour has been entirely procyclical, as they first encourage overinvestment in these markets and then promote a massive exodus of capital. Thus, rather than helping to smooth out financial cycles as a proper information system should, they have tended to accentuate them.

These circumstances, of which you are all fully aware, have made it necessary for the Group of Seven (G-7) to take concerted action to counter the threat of worldwide deflation, and to provide the resources needed to help developing countries that are experiencing temporary difficulties to increase the cost of mounting a speculative attack on their currencies.

1. An institutional framework for financial globalization

In addition to the inadequacy of the steps taken thus far, the seriousness of the current situation tells us that the time has come to embark upon the task of creating a new and more appropriate institutional structure for the financial globalization process. This new structure must be equipped with sufficient resources and a greater capacity for preventive action but, perhaps even more

importantly, it must also include proper international regulatory and supervisory systems.

Furthermore, this updating and modernization of our 'institutional architecture' must be broad in scope. It must provide for means of filling in the gaps that exist in the regulation of various market agents in the industrialized countries themselves. Above all, it must incorporate a new perspective that paves the way for the modernization of the institutions that now govern national and international economic relations and of the development concepts on which we base our actions.

We have arrived at a very important juncture in terms of the historic events that are transforming contemporary society, one that calls for a fresh perspective and new institutions to aid us in meeting the ongoing challenges of the struggle for social equity, justice and progress. At the opening session of the meeting of the Board of Governors of the Inter-American Development Bank, in early 1999, I raised the subject of the relationship between institutions and the market in a world in which the globalization process holds sway. If dynamic market development is the result of a reduction in regulations in all the countries, and if the globalization process is being manifested in the unfettered movement of knowledge, goods and capital across national borders, then why are multilateral agencies and the leaders of so many countries so concerned about institutions, institutions that hark back to an order that is now disappearing?

We have learned that the economic system and institutions that govern our actions are not a rigid or inexorable fact of life. On the contrary, to put it simply, institutions are nothing more than social and economic 'ground rules', whether written or unwritten. Institutions are manifested in trade practices, contracts, social norms, respect for the rights and property of others, the exercise of one's rights and the fulfilment of one's duties as a citizen, as well as in constitutions, laws and regulations. Institutions thus provide the framework for our economic, political and social interaction and, in so doing, lessen the uncertainty and the costs of that interaction. Therefore, institutions do not conflict with the operation of the market or with globalization but are instead an essential part of those processes. Moreover, market liberalization and globalization have aroused renewed interest in our institutions at the national, regional and international levels.

Our options and opportunities for trade and information exchange have mushroomed in the past few decades, and so have a wide range of other variables and situations, that are beyond the control of individual economic and social agents, because of differences in terms of information, size, objectives and many other factors.

The perceived level of systemic risk existing in the world today is what has fuelled the growing demand for a reassessment of our international 'financial architecture', and for ways of rectifying serious shortcomings in the institutional structures of countries which until recently inspired great enthusiasm in the market.

The updating and modernization that we are seeking does not, of course, involve turning back to the institutions of the past. We have seen what benefits globalization and the operation of the market have to offer, and we therefore must not repress these processes. The world of today needs institutions that will help to perfect, rather than inhibit, the operation of the market; that will increase, rather than diminish, the flow of information; that will permit more competition and fewer monopolies; that will allow ideas, initiative and well planned ventures to prevail over the abuse of authority and the concentration of economic, political or corporate power.

In order for a genuine process of institution-building to flourish, institutions must be seen as a source of opportunities for incorporating new sectors and ideas into the development process, rather than as a source of constraints on market development or globalization.

This is particularly true in the case of institution-building at the regional and global levels. But international relations, even in this post-Cold War era, tend to be dominated by the political realities of the immense imbalance of power existing between different nations and regional blocs. The real test of any new international institutional structure will be its ability to establish ground rules that will reduce uncertainty, and allow all countries to establish a presence and make their voice heard in the international economic and political system.

2. Institutions and civil society

Institution-building is a basic component of the myriad changes associated with the new international economic order –and, more generally, contemporary society– and the ultimate outcome of that process is as yet unknown. But not just any sort of institution will help us to create a more humane economy and a better society. The kinds of institutions we need are those that, in addition to increasing the transparency of market forces and making them more equitable, will help us to improve our democratic system and to broaden and deepen civil society.

When people analyze or discuss economic or financial globalization, they rarely consider the issues involved in democracy or civil society. Nevertheless, experience teaches us that a broad-based, open, cultured and

organized civil society is our principal avenue for the creation of an advanced society of the type we seek.

The nature and quality of civil society are determined by its intermediate organizations, by the dynamism and pluralism of its associations, by the degree to which the people participate in its businesses and organizations, by the sense of responsibility of its elites, by the potency and depth of its ethical and spiritual values and by the solidarity, spirit of cooperation and sense of shared responsibility that are expressed –or not expressed– in its economic, social and political affairs. Only if we are able to imagine and develop suitable institutions for the formation of a sufficiently solid and developed civil society, at the national and international levels, can we hope to achieve greater democracy, greater economic equity and genuine peace.

The future course of events may turn out to be quite different from what I have described here. However, history teaches us that ideas have a life of their own and that the search for a more humane economy and a better society has been a constant throughout mankind's history, and has been especially intense when people are not taken into consideration in resolving the problems of the communities in which they live.

We have come to the end of the second millennium of the Christian era, at a point in time that has enabled us to witness a vast array of scientific and technological advances. There are some, however, who think that we are heading towards the type of dehumanization associated with competitive, consumer-oriented individualism, whose goal is 'having' rather than 'being'.

This view is based on a concept of society according to which it is nothing more than the sum total of its individual members, who compete with one another on some sort of 'spontaneous' basis, with the market –through something akin to a 'Darwinian' evolutionary process– providing the context for the survival of the 'fittest'. This construct is incompatible with the truths and principles of humanism, and has actually turned out to be even more mistaken than we had imagined. Human beings are not just individuals who were put on this earth to compete in the market. First of all, we are people with a sense of belonging, people who, from the moment of our birth and throughout our lives, are members of many different communities to which we belong as part of a natural process. Each of us is part of a family, a neighbourhood, a district or city. We all grow and mature, at school and in our jobs. Each person is, ultimately, a basic building block of the national community, and that community in turn makes up the larger community of mankind. Our identity as members of a larger whole is what helps to hold society together, what provides the framework for our lives and what empowers us by enabling us to overcome individualistic, exclusionary forms of competitiveness.

Life in society is much more than competition among individuals for wealth or power. There is such a thing as the 'common good', common to society as a whole and to the people who form it. This is the reason for the existence of the State, which is nothing more than the juridico-political organization of national societies that is supposed to uphold the rule of law, dispense justice and, above all, promote the common good. If the task before us now is to promote and direct the development process towards the attainment of living conditions that enhance human dignity, then it is essential for us to develop a civil society that gives meaning to our lives as part of a community and imbues it with humanity.

As we have learned after many advances and setbacks, development is more than simply economic growth; it is progress towards a fuller life, both materially and spiritually. Pope John Paul II has reminded us of this, when he warned that any form of economic development that does not take human and moral considerations into account will tend to crush people's spirits, and that the purpose of the economy, our jobs and businesses is, first and foremost, to serve people. It is awareness of this fact that led the United Nations to formulate the concept of 'human development', which is measured not only by countries' wealth or rate of economic growth but also by various indicators of the quality of life, such as health, education, participation, among other things.

We are in the midst of a series of changes whose assimilation is necessarily slow, uneven and difficult. The technological revolution that has taken place in our forms of production and organization demands complementary economic and socio-political changes on a global, national and local scale, but thus far these changes have fallen far short of what is needed in terms of their magnitude and scope. It is our duty to help maintain the direction, orientation and coherence of these changes, to enhance the human and participatory dimension of the new structures that are to come, to make it clear that cooperation is better than rivalry and merciless competition, and that teamwork and mutual aid are more effective than mistrust, exclusion and unfeeling individualism.

3. Conclusions

Our discussion of crucial issues in this international seminar will allow us to broaden our perspective, as we seek to find positive solutions to many of the problems troubling our nations today. Our inputs and conclusions will aid us in our shared quest for a more humane economy and a better society.

We are crossing the threshold into a new era of civilization, as Jacques Maritain would call this profound and ethically committed vision of the future. Human society's development confronts us with the necessity of

committing ourselves to work towards a genuinely humane community. In his correspondence with my father, Maritain said that 'if we, as Christians, fix our gaze on the lowest plane of political affairs, we cannot help but betray our calling. It is on the plane of truth and of the testimony which God calls upon us to give that we should pursue our worldly duties and direct our social and political strivings.'

Maritain wrote that in 1970, when the ideological and economic map was radically different from what it is today, but the validity of his words for all Christians who have entered the world of politics remains undiminished.

PART I
INTERNATIONAL FINANCIAL REFORM

5. A BROAD AGENDA FOR INTERNATIONAL FINANCIAL REFORM

*José Antonio Ocampo **

1. Introduction

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

The crisis set in motion positive responses: a concerted expansionary effort led by the United States, which was probably the crucial step that facilitated the fairly rapid though incomplete normalization of capital markets in 1999; the approval of new credit lines and the expansion of International Monetary Fund (IMF) resources; the recognition that incentives must be created to induce adequate debt profiles in developing countries; a special impetus to international efforts to establish minimum standards of prudential regulation and supervision of financial systems, as well as of information; the partial acceptance by the IMF that fiscal overkill is inappropriate in adjustment programmes; the improvement of the Highly

* Executive Secretary, United Nations Economic Commission for Latin America and the Caribbean (ECLAC), Santiago.

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

Indebted Poor Countries' (HIPC) Initiative; and the greater emphasis given to the design of adequate social safety nets in developing countries. Some responses were positive but do not seem to be leading in any clear direction (or even in a wrong one). This is the case of the adoption of collective action clauses in debt issues as an essential step to facilitate internationally agreed debt standstills and workout procedures. In some cases, the responses were insufficient or clearly inadequate: IMF conditionality was overextended; the issues associated with stable arrangements to guarantee the coherence of the macroeconomic policies of industrialized countries did not receive sufficient scrutiny; the Japanese proposal to create an Asian Monetary Fund (AMF) gave rise to strong unwarranted opposition that led to its rapid dismissal; more generally, the role which regional institutions can play in an appropriate international financial arrangement was not given adequate attention; and no steps were taken to ensure a fair representation of developing countries in the discussions on reform or in a revised international architecture.

The fairly rapid normalization of capital markets seems to be giving way to a sense of complacency that could slow down the reform effort. Moreover, it may lead efforts in the wrong direction. One such step would be to give new impetus to discussions on capital account convertibility. The calmer environment could be taken, on the other hand, as an opportunity to broaden the agenda and to set in motion a representative, balanced negotiation process. The agenda should be broadened in at least two senses: first of all, it should go beyond the issues of financial crisis prevention and resolution (which may be termed the 'narrow' financial architecture²) to include those associated with development finance and the 'ownership' of economic and, particularly, development policies; secondly, it should consider, in a systematic fashion, not only the role of world institutions, but also of regional arrangements and the areas where national autonomy should be maintained. This is the focus of this chapter. As a background, the next section presents brief reflections on the nature of the problems that the system faces. The chapter then deals with crisis prevention and management, development finance, the issue of conditionality vs. 'ownership' which concerns both of them, the role of regional institutions and the realms of national autonomy.

2. The nature of the problems that the system faces

International capital flows to developing countries have exhibited four outstanding features in the 1990s.³ First of all, official and private flows have exhibited opposite patterns: whereas the former have tended to decline, private capital flows have experienced rapid medium-term growth, Secondly,

2 Ocampo (1999a).

3 For a full evaluation of trends, see UNCTAD (1999), Chapters III, V; World Bank (1999).

different private flows have exhibited striking differences in terms of stability. Thirdly, private flows have been concentrated in middle-income countries, with official flows playing only a very partial redistributive role at a world level. Finally, the instability of private financial flows has required the design of major emergency rescue packages, of unprecedented size, which have concentrated funds in a few large 'emerging' economies.

The first two patterns are shown in Table 5.1. Both foreign direct investment (FDI) and all types of private financial flows have experienced strong medium-term growth. However, these flows have exhibited striking differences in terms of stability: whereas FDI has been resilient in the face of crises, private financial flows have experienced strong volatility and 'contagion' effects. In contrast, official development finance –and particularly its largest component, bilateral aid– has lagged behind. Indeed, bilateral aid fell in real terms throughout the decade, and in 1998 it was estimated to have reached 0.22% of the GDP of industrialized countries, a significant fall with respect to the 0.35% of GDP reached in the mid-1980s.⁴

Table 5.1
NET LONG-TERM RESOURCE FLOWS TO DEVELOPING COUNTRIES, 1990-98
(billions of U.S. dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998 ^a
Total	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Official flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
From int. 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 investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0

Source: The World Bank, *Global Development Finance 1999*.

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

^a Preliminary.

⁴ World Bank (1999), Chapter 4, p. 70.

The third pattern is shown in Table 5.2. Private flows have been strongly concentrated in middle-income countries. The share of low-income nations in private financing has been lower than their share in the total population of developing countries, a fact that may be expected, but it is also lower than their share in developing countries' GDP. This fact is particularly striking in bond financing, commercial banking and portfolio flows, if India is excluded in the latter case. In all these cases, private financing to poor countries is minimal. The share of low-income countries in FDI is also smaller than their contribution to developing countries' GDP. Moreover, a striking feature of FDI is its high concentration in China, which captures, on the contrary, a smaller proportion of financial flows. The high concentration of the most volatile flows in middle-income countries, excluding China, has implied, in turn, that issues of financial volatility and contagion have become particularly relevant to them.

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

The volatility of private financial flows, on the one hand, and its strong concentration in middle-income countries, on the other, have jointly generated the need for exceptional financing on an unprecedented scale, which has been concentrated in a few 'emerging' countries. As a result of this feature, the share of IMF financing going to large borrowers has displayed a strong upward trend over the past two decades.⁵ In the context of a significant scarcity of official financing for low-income countries, the high concentration of balance of payments financing in a few large 'emerging' economies raises significant concerns as to the global rationality with which global capital flows, and even official flows, are distributed. It certainly raises question about whether the problems of the largest developing countries generate specific biases in the response of the international community.

5 Griffith-Jones and Ocampo (1999).

Table 5.2
NET FLOW OF RESOURCES , 1992-97
(annual averages, billions of U.S. dollars and percentages)

	Foreign direct investment		Portfolio equity 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
Republic of Korea ^b	1.5	1.5	3.1	8.8	0.0	0.0	-0.2	-5.4	0.6	4.1
Mexico	8.1	8.2	5.1	14.3	0.0	0.1	-0.6	-21.4	0.3	2.2
Other countries	33.0	33.3	10.7	30.1	12.2	41.2	0.1	2.2	3.0	21.7
	Bonds		Commercial bank loans		Other loans		Total		Memo: GDP Population	
	Amount	Per-centage	Amount	Per-centage	Amount	Per-centage	Amount	Per-centage	Amount	Per-centage
Developing countries	34.6	100.0	28.3	100.0	4.9	100.0	248.7	100.0	100.0	100.0
Excluding China	32.9	95.2	26.6	94.0	1.1	21.4	200.7	80.7	89.2	74.8
Low-income countries	0.5	1.5	0.9	3.3	0.4	7.2	34.5	13.9	11.4	41.0
India	0.4	1.1	0.8	2.8	0.4	8.9	6.9	2.8	5.6	19.3
Other countries	0.2	0.4	0.2	0.6	-0.1	-1.7	27.6	11.1	5.8	21.7
China^a	1.7	4.8	1.7	6.0	3.9	78.6	48.0	19.3	10.8	25.2
Middle-income countries	32.4	93.7	25.7	90.7	0.7	14.2	166.3	66.9	77.8	33.9
Argentina	5.5	15.9	0.8	2.9	0.0	-0.9	13.3	5.3	5.0	0.7
Brazil	3.1	9.0	8.2	29.0	-0.6	-11.3	21.2	8.5	10.5	3.3
Russian Federation	0.8	2.2	0.3	1.1	1.4	28.7	8.1	3.2	7.3	3.1
Indonesia	1.6	4.7	0.9	3.2	0.2	3.7	10.2	4.1	3.4	4.0
Republic of Korea ^b	4.5	12.9	4.1	14.5	-0.2	-4.8	13.4	5.4	7.3	0.9
Mexico	5.2	15.2	0.3	1.1	-0.3	-6.9	18.2	7.3	6.7	1.9
Other countries	11.7	33.8	11.0	38.9	0.3	5.6	81.9	32.9	37.6	19.8

Source: The World Bank, *Global Development Finance, 1999*, Washington, D.C., March 1999 and *World Economic Indicators*, Washington, D.C., 1998 for GDP and population data.

^a The World Bank considered China as a low-income country until 1998. Since 1999 it has been classified as a middle-income country. In this table it is considered as a specific category.

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

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

3. Financial crisis prevention and resolution⁶

With respect to financial crisis prevention and resolution, the most important area of agreement relates to the need to improve the institutional framework in which financial markets operate: to strengthen prudential regulation, supervision and accounting practices of financial systems worldwide, to adopt minimum international standards in these areas and sound principles of corporate governance and to improve the information provided to financial markets. From the point of view of industrialized countries, the central issues for the corresponding domestic agencies are stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres and the greater weight that should be given to the risks associated with operations with countries engaging in large-scale net borrowing, particularly of a short-term character, to discourage risky financing at the source.

From the point of view of borrowing economies, greater weight should be given by domestic regulators to the accumulation of short-term liabilities in foreign currencies, to risks associated with the rapid growth of credit, to currency mismatches of assets and liabilities and to the valuation of fixed assets as collateral during episodes of asset inflation. Most importantly, due account should be taken of the links between domestic financial risks and changes in key macroeconomic policy instruments, notably exchange and interest rates. This indicates that prudential standards should be stricter in developing countries, where such links are more important, and that they should be strengthened during periods of financial euphoria to take into account the increasing risks being incurred by financial intermediaries.

Nonetheless, a substantial divergence of opinion remains. First, there is no consensus as to which institutions should be entrusted with enhanced

6 See, among others, Camdessus (1998); Griffith-Jones (1998); Group of Seven (1998); IMF (1998); IMF Interim Committee (1998); Miyazawa (1998); UNCTAD (1998); Akyüz and Cornford (1999); Eatwell and Taylor (2000); Eichengreen (1999); Griffith-Jones and Ocampo (1999); Ocampo (1999a, 1999b); Rubin (1999); United Nations Task Force (1999a); White (1999); Wyplosz (1999).

responsibilities in this field. The BIS should certainly play the leading role, but this requires a significant expansion of developing country membership in this organization, and of developing country participation in the definition of all sorts of international standards and codes of conduct, in general. The more ambitious proposal to create a World Financial Authority on the basis of BIS and OIOS should also be considered.⁷ Secondly, although the essential role of regulation and supervision is to make financial intermediaries more risk-conscious, there are clear limits to the appropriateness of discouraging private risk-taking. Thirdly, differences exist as to the relative merits of prudential regulations and supervision vs. alternative instruments in key areas. One particularly relevant issue in this regard, as we will see below, relates to capital account regulations. Fourthly, there are significant differences of opinion as to what can be expected from enhanced prudential regulation and supervision, given their inherent limitations. Regulations will tend to lag behind financial innovations, supervisors are likely to face significant information problems and macroeconomic events may overwhelm even well regulated systems. Finally, traditional prudential regulation and supervision tend to have procyclical macroeconomic effects (they may be unable to avoid excessive risk-taking during the booms and accelerate the credit crunch during crises, when bad loans become evident and the effects of provisioning standards are thus felt), a fact which may increase rather than decrease credit risks through the business cycle.

Consensus on the need to strengthen the institutional framework has not been matched by a similar emphasis on the role of macroeconomic surveillance and consultation. This issue is crucial in relation to both booms and crises, but the need to strengthen the extremely weak existing arrangements is particularly crucial during booms, when major crises are incubated. Indeed, the focus of current institutions –both national and international– on crises rather than booms is a serious deficiency of existing arrangements, as they underplay the preventive role that they should perform. Obviously, concerted expansionary action during crises is also essential and, as was pointed out in the Introduction to this chapter, moves in that direction since the Russian crisis are probably the single most important reason for the relative though incomplete normalization of capital markets in 1999. The lack of adequate representation of developing countries is another deficiency of current arrangements. Proposals to strengthen macroeconomic surveillance should thus be accompanied by an increased representation of developing countries in the corresponding policy organs.

The enhanced provision of emergency financing during crises is the third pillar of the system to prevent and manage financial crises. The main lessons from recent crises are: (1) that large-scale funding may be required, though not

7 Eatwell and Taylor (2000).

all of it needs to be disbursed if support programmes rapidly restore market confidence; (2) that funds should be made available *before* –rather than after– international reserves reach critically low levels; and (3) that, due to strong contagion effects, contingency financing may be required even by countries that do not exhibit fundamental disequilibria. Positive measures have been adopted in this area, including a significant expansion of IMF resources through a quota increase and the New Arrangements to Borrow, which finally entered into effect in late 1998; the launching of a new window in December 1997 to finance exceptional borrowing requirements during crises; and the creation of the Contingency Credit Line in April 1999 to provide financing to countries facing contagion, though under very restrictive eligibility requirements. Much remains to be done in terms of improving existing facilities, as well as in guaranteeing that adequate funds are available at times of crises. In this regard, emergency financing has continued to rely on bilateral financing and contributions to the IMF, which may come in inadequate amounts and are subject to delays due to the political negotiations involved in raising them. An alternative solution is to allow additional issues of SDRs during episodes of world financial stress; these funds could be destroyed once financial conditions normalize.⁸ This procedure would create an anti-cyclical element in world liquidity management and would give SDRs an enhanced role in world finance, a principle that developing countries have advocated in the past and should continue to endorse in the future. Second-best alternatives are to make a more active use of Central Bank swap arrangements under IMF or BIS leadership, and to allow the IMF to raise the resources needed in the market.

The fourth pillar is debt standstills (also referred to as orderly workout procedures). This mechanism is essential to avoid the coordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments by private lenders and, thus, to avoid ‘moral hazard’ issues associated with emergency financing. Due to the effects that its use could have on their credit standing, borrowing countries are unlikely to abuse it. Nonetheless, to avoid ‘moral hazard’ issues on the side of borrowers, it must be subject to international control, either by requiring prior IMF approval or by allowing countries to call a standstill unilaterally but then requiring that they submit it for approval by an independent international panel, whose authorization would give it legitimacy.⁹ A third alternative could be to draft *ex ante* rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks were experienced; such rules have sometimes been incorporated into debt renegotiation agreements.

8 See United Nations Task Force (1999a).

9 UNCTAD (1998), Part I, Chapter IV; United Nations Task Force (1999a).

The active use of this mechanism has four implications. First, to avoid both free-riding and discrimination against countries or group of countries that adopt it, it requires the *universal* adoption of ‘collective action clauses’ in international lending. The G-7 countries should actually lead the process, as they suggested in October 1998, for otherwise it may become an additional source of discrimination against ‘emerging markets’.¹⁰ Secondly, ‘bailing in’ should be encouraged by giving seniority to lending that is extended to countries during the period in which the standstill is in effect and during a later phase of ‘normalization’ of capital flows. Thirdly, debt renegotiations under this framework must have a short, strictly defined time horizon beyond which the IMF or the independent panel would have the authority to determine the terms of rescheduling. Finally, to avoid repeated renegotiations –the most troublesome features of debt reschedulings in recent years– aside from the portion that is written off (or refinanced in highly concessional terms), the service of another portion should be subject to the fulfilment of certain contingent macroeconomic conditions that determine debt service capacity (e.g. terms of trade, normalization of lending, domestic economic activity, etc.).

The most problematic of all rescheduling processes in recent decades have been those associated with highly indebted poor countries (HIPC). The HIPC Initiative has been slow in its operation due to the complexity of the process required to determine eligibility (and, obviously, the conditionality attached to it), the inadequate definition of debt sustainability levels, and the lack of adequate funding.¹¹ The Cologne Debt Initiative (1998) may serve to overcome some of these problems, providing ‘faster, deeper and broader debt relief’.¹² It is essential, of course, that aside from eligibility criteria and the implementation of the most generous terms, additional funding become effectively available. In particular, in an environment of scarcity of ODA funds, it is essential that the funds allocated to HIPC should not crowd out fresh ODA. This would be regrettable, as new financing is a necessary complement to debt relief and the latter is unlikely, by itself, to accelerate economic growth in highly indebted poor countries.

The definition of international rules on capital account regulations and exchange rate regimes has been left out of this discussion. The reason is that, under the current, incomplete arrangements, national autonomy should continue to prevail in these areas. They are therefore considered in Section 8 below.

10 Group of Seven (1998).

11 United Nations Task Force (1999b).

12 Group of Seven (1999).

4. Development finance

As the discussion presented in Section 2 indicates, although adequate financing from the IMF is certainly important to low-income countries, the major issues for them are associated with the need to guarantee adequate development finance, through ODA and multilateral lending, and to generate mechanisms that will allow them to participate more actively in private capital markets. Given the relative magnitude of financing to low-income countries (see Table 5.2), the reversal of ODA flows, particularly those originating in the largest industrialized economies, is certainly the most important issue. As we have pointed out, it is important that efforts to accelerate HIPC should not crowd out new ODA financing in the budgetary processes of the industrialized countries. Actually, beyond a more ambitious HIPC Initiative, the world requires an even more ambitious and permanent 'ODA Initiative' aimed at effectively meeting internationally agreed targets. An essential characteristic of this process, as is emphasized in the following sections, should be an effective 'ownership' of policies by developing countries, a fact that requires less direction from abroad and more emphasis on national institutional development. The latter requires, in turn, respect for the central role that parliaments and governments in aid-receiving nations should have in the global allocation of aid through their budgetary processes and the central role that governments in those countries should have in directing traditional areas of public policy (e.g. social policy and infrastructure), even when civil society is given a central role in execution.

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

The first of these functions underscores the central role that financing from IBRD-IDA and the regional and subregional development banks will continue to play in the immediate future. The second and third functions emphasize the role that official development financing will continue to play even for middle-income countries. It must be stressed, however, that the

anti-cyclical provision of funds should not be confused with the provision of emergency balance of payments financing, which is essentially a task of the IMF. In any case, the large-scale requirements for counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries, a point which has been made by the President of the World Bank.¹³ Thus, if multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it should certainly be of secondary importance relative to its first two roles, particularly the provision of long-term development financing to poor countries. This is underscored by the data from Table 5.2, which indicate that multilateral financing in 1992–97 represented only 13% of that provided by the private sector, excluding FDI, and only 6% in the case of middle-income countries. Thus, a useful counter-cyclical function would certainly require a significant increase in resources.

The fourth function is of fairly recent origin but has been rapidly gaining in importance in the 1990s and should become one of the primary focuses of multilateral financing in the future. This function has been associated in the recent past with direct financing to the private sector (by banks or associated financial corporations) or with the design of guarantee schemes to support private infrastructure projects in developing countries. It could also be used to support developing countries' efforts to return to markets during crises and, even more importantly, to support initial bond issues by developing (particularly poor) countries seeking to position themselves in private capital markets. Cofinancing or guarantee schemes could be used for that purpose. It must be emphasized, however, that the full development of these schemes would require a radical change in the management of guarantees by development banks as, under current practices, guarantees are treated as if they were equivalent to lending, a fact which severely restricts the banks' ability to extend them. Such an expansion of the role of development banks in guaranteeing private financing has been criticized on the grounds that it could involve excessive risk-taking by these institutions. Nonetheless, in a world that will probably be dominated by private financing, it may be absolutely essential to prevent low-income countries from being left out of major developments in capital markets. It should thus receive priority attention in current discussions.

In recent debates, a correct emphasis has also been placed on the role that multilateral development banks should play in financing social safety nets in developing countries. Strong social safety nets are, indeed, essential in managing the social repercussions of financial vulnerability in the developing world. The preferred mechanism since the late 1980s has been social emergency funds (later transformed in many countries into more stable social

¹³ Wolfensohn (1998).

investment funds). Although they have introduced some innovations in social policy (e.g. competitive mechanisms to allocate resources and civil-society participation in social policies), their effects have been rather limited, their targeting has not always been effective and they may have crowded out resources from long-term social policies.¹⁴ Other instruments have also been used in the past by developing countries, including some types of unemployment insurance (the major instrument of its kind in the industrialized world), emergency employment or emergency labour-intensive public works programmes, income-support schemes in conjunction with training and some nutrition programmes. The recent crisis seems to have led to the design of new instruments: special subsidies to households with school-age children that are tied to school attendance and various support programmes aimed at ensuring that households with an unemployed head of household do not lose their home during crises.

Recent analyses have come to some basic conclusions about these programmes. Firstly, safety nets must be part of *permanent* social protection schemes, as only a permanent scheme guarantees that the programme coverage will respond without lags to the demand for protection of vulnerable sectors during crises.¹⁵ This implies, in turn, that financing must be fundamentally of a domestic character, with external financing contributing marginally, if at all, during crises (see below). Secondly, given the heterogeneity of labour markets in developing countries, a combination of several programmes, with different target groups, is necessary.¹⁶ Thirdly, these programmes must be adequately financed and should not crowd out resources from long-term investment in human capital. This, it must be said, leads to a fourth conclusion: that the effective functioning of social safety nets requires that public sector expenditure should include anti-cyclical components. This would be impossible –without generating inefficiencies in the rest of public sector expenditure– unless fiscal policy as a whole is counter-cyclical, a point that has not been sufficiently emphasized in current discussions.

5. Conditionality vs. 'ownership'

The most controversial issue behind international emergency and development financing is certainly conditionality. In the case of the IMF, this issue has long been a central area of contention. However, in recent years –and even decades– the issue has become increasingly troublesome, particularly as a result of the fact that the scope of conditionality has been gradually

14 See, in particular, Cornia (1999). See also ECLAC (1998b), Chapter VI; Graham (1994).

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

16 Márquez (1999).

expanded to include not only the realms of other international organizations –quite often, for example, that of the WTO and the development banks– but also of domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated, ‘by their very nature should be decided by legitimate national authorities, based on broad social consensus’.¹⁷

Thus, even if the legitimacy of the principle of conditionality –or, as it is sometimes stated, ‘support in exchange for reforms’– is accepted, there is reason to review the characteristics of such conditionality. Indeed, the perception that conditionality has been carried beyond what may actually be necessary in order for the Fund to perform its functions properly may be helping to undermine its legitimacy. Thus, a strong argument can be made that the way to restore full confidence in the principle of conditionality is by reaching a renewed international agreement on how it should be used.

Several principles can be advanced in this regard. First, conditionality should be restricted to the macroeconomic policies that were its purview in the past. It should be used when expansionary policies are clearly associated with the generation of macroeconomic imbalances, or when a country needs to draw Fund resources above and beyond some automatic level of low-conditionality facilities, if the source of the imbalance is an international shock. Reforms of domestic prudential regulation and supervision may also be required, but in this case parallel agreements should be made with the corresponding international authorities. Secondly, low-conditionality facilities should be available in adequate quantities when the source of the imbalance is an international shock. This principle should be fully recognized in the new contingency credit line available to countries facing contagion. Thirdly, as we have also noted, more stringent credit terms should not be used as a complement to conditionality. Fourthly, automatic rules should be agreed upon when signing an agreement with the Fund under which the restrictiveness of the adjustment programme would be eased should evidence of overkill become clear. Finally, regular official evaluation of IMF programmes, either by an autonomous division of the Fund (as is done in the World Bank) or by outside analysts, should be introduced and the major conclusions of these evaluations, following their review by the Board, should be explicitly incorporated into regular Fund practices.

Similar issues should be raised in relation to development finance. With respect to this issue, a World Bank report (1998) which analyzes the success of structural lending, according to its own evaluation, comes to the conclusion that conditionality does not influence the success or failure of such programmes at all.¹⁸ Nonetheless, according to the same report, aid

17 United Nations Task Force (1999a), Section 5. See also Feldstein (1998); Rodrik (1999).

18 See World Bank (1998), Chapter 2 and Appendix 2.

effectiveness is not independent of the economic policies that countries follow. However, in terms that are now familiar in the aid literature, the *ownership* of adequate economic policies –i.e. the commitment of national authorities to them– is what really matters. Conditionality has *no* additional contribution to make in these cases, and it is obviously ineffective in the case of countries that do not follow good policies.

Curiously enough, on the basis of this study the World Bank draws the conclusion that conditionality is good after all. Hence, it claims that ‘Conditional lending is worthwhile where reforms have serious domestic support’¹⁹ and, in particular, that it ‘still has a role –to allow government to commit to reform and to signal the seriousness of reform– but to be effective in this it must focus on a small number of truly important measures’.²⁰ This statement is certainly paradoxical if the conclusions of the report are taken at face value. Rather, this study raises serious doubts about the rationality of conditionality itself, a fact which is, indeed, implicit in the idea that ‘ownership’ of economic policies is, after all, the essential issue.²¹

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

6. The role of regional institutions

The current discussion has underscored the fact that some services provided by international financial institutions, including some ‘global public goods’, are being undersupplied. However, it would be wrong to conclude from this statement that the increasing supply should come from a few world organizations. Rather, the organizational structure required should have, in some cases, the nature of networks of institutions that provide the services required on a complementary basis and, in others, should function as a system of competitive organizations. The provision of the services required for financial crisis prevention and management should be closer to the first model whereas, in the realm of development finance, competition should be the basic rule (and, in fact, should include competition with private agents as well). But

¹⁹ *Ibid.*, p. 48.

²⁰ *Ibid.*, p. 19.

²¹ See a full discussion of these issues in Helleiner (1999).

purity in the model's structure is probably not the best characteristic: it is desirable that parts of networks compete against each other (e.g. regional reserve funds vs. the IMF in the provision of emergency financing) and that competitive organizations cooperate in some cases.

This implies that the IMF of the future should not be viewed as a single, global institution, but rather as the apex of a network of regional and subregional reserve funds. To encourage the development of the latter, incentives could be created by which common reserve funds could have automatic access to IMF financing and/or a share in the allocation of SDRs proportional to their paid-in resources –in other words, contributions to common reserve funds would be treated as equivalent to IMF quotas.²² Regional reserve funds could provide most of the exceptional financing for smaller countries within a region, but also part of the financing for larger countries, and they could also serve to deter, at least partly, would-be speculators from attacking the currencies of individual countries.

This model should be extended to the provision of macroeconomic consultation and surveillance, as well as to coordination and surveillance of national systems of prudential regulation and supervision. Thus, regional and subregional systems, including peer review mechanisms, should be designed to internalize the externalities that macroeconomic policies generate on neighbours. This would complement, rather than substitute for, regular IMF surveillance. In the area of prudential regulation and supervision, more elaborate systems of regional information and consultation, including the design of specific regional 'minimum standards', can also play a positive role. Again, peer reviews should be part of this system.

It is important to emphasize that subregional development banks can play a significant role as a mechanism to pool the risks of groups of developing countries, thus allowing them to make a more aggressive use of opportunities provided by private capital markets. In Latin America, an interesting experience in this regard is that of the Andean Development Bank (*Corporación Andina de Fomento*, CAF). The fact that the credit ratings of this institution have exceeded those of Colombia, the only Andean country that was classified as 'investment grade' in the 1990s and was thus able to issue debt obligations on favourable terms, indicates that such a risk-pooling policy can be very effective.

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

22 United Nations Task Force (1999a), Section 9; Ocampo (1999a).

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

7. The realms of national autonomy

Whatever international system is developed, it is clear that it will continue to be a very imperfect 'financial safety net'. Consequently, a degree of 'self-insurance' by countries will continue to be essential to avoid financial crises, as well as to avoid 'moral hazard' issues intrinsic to any support scheme. This raises two issues as to the national policies necessary to guarantee financial stability and the areas where national autonomy should be maintained. We will argue that the international system should continue to maintain national autonomy -at the least in the case of developing countries- in two critical areas: the management of the capital account and the choice of the exchange rate regime. The choice of development strategies is obviously an additional, essential realm in which national autonomy should prevail, as the analysis in Section 6 has emphasized.

A major issue of contention in the current debate is that relating to the possibility of defining common international rules in the area of capital account liberalization. Massive evidence of liberalizations that ended up in major external and domestic financial crises in developing countries have led to several agreements in this area. It is now generally agreed that such liberalizations should be gradual, should emphasize longer-term funds and be extremely cautious with shorter-term and volatile funds and should be preceded by the development of strong financial regulation and supervision and by consistent macroeconomic policies. Moreover, it is also accepted that any international agreement in this area should include safeguard mechanisms that would allow a temporary use of controls under certain, critical conditions. The consensus stops at this point. A strong argument has been made that well managed capital account liberalization should be the final objective in any case, as freer capital markets are inherently good for growth and, thus, the recourse to capital controls should be essentially temporary. These are the assumptions that underlie the current discussion on the introduction of capital account convertibility into the Articles of Agreement of the IMF. A strong argument can be made, however, on the advantages of maintaining the autonomy of developing countries to manage the capital account.

There are actually no strong arguments in favour of moving towards capital account convertibility.²³ There is no evidence that capital mobility leads to an efficient smoothing of expenditures in developing countries through the business cycle and, on the contrary, strong evidence that in these

countries the volatility of capital flows is an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and there are some indications that point in the opposite direction.²⁴ A simple way to pose the issue is to argue that, even if it were true that freer capital flows through their effects on a more efficient savings–investment allocation process, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect. As has been pointed out already, the absence of an adequate international financial safety net is an equally important argument in this connection. Why should developing countries give up this degree of freedom if they do not have access to adequate amount of contingency financing with well defined conditionality rules, and no internationally agreed standstills and debt workout procedures? This is a crucial issue for countries without significant power in the international arena, for whom renouncing any possible means of crisis management is a costly alternative. Indeed, there are strong similarities between today's international financial world and the era of 'free banking' at the national level: in the absence of central banks as lenders of last resort and officially managed bank rescue schemes, inconvertibility of private bank notes was a necessary legal alternative in the face of bank runs.

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

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

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

8. Conclusions

This chapter has argued that the agenda for international financial reform must be broadened in at least two senses. First of all, it should go beyond the issues of financial prevention and resolution, on which the recent debate has focused, to those associated with development finance for poor and small countries, and to the 'ownership' of economic and development policies by countries. Secondly, it should consider, in a systematic fashion, not only the role of world institutions but also of regional arrangements and the explicit definition of areas where national autonomy should be maintained. These issues should be tabled in a representative, balanced negotiation process, which should overcome some of the adverse political economy features that characterize the current debate.

In the area of financial crisis prevention and resolution, a balance must be struck between the current emphasis on the need to improve the institutional framework in which financial markets operate and the still insufficient attention to or action on the design of appropriate schemes to guarantee the coherence of macroeconomic policies worldwide, the enhanced provision of emergency financing during crises and the creation of adequate debt standstill and orderly debt workout procedures. In the area of development finance, emphasis should be given to the need to increase funding to low-income countries, including the use of multilateral development finance to support increased participation of low-income and small middle-income countries in private capital markets. The role of multilateral development banks in the financing of social safety nets during crises must also be emphasized. The enhanced provision of emergency and development financing should be accompanied by a renewed international agreement on the limits of conditionality and a full recognition of the central role of the 'ownership' of development and macroeconomic policies by developing countries.

It has also been argued that regional and subregional institutions should play an essential role in increasing the supply of 'global public goods' and other services in the area of international finance. The necessary financial architecture should in some cases have the nature of a network of institutions that provide the services required in a complementary fashion, and in others (particularly in development finance) should exhibit the characteristics of a system of competitive organizations. The fact that any new order would continue to have the characteristics of an incomplete 'financial safety net' implies both that national policies would continue to play a disproportionate role in crisis prevention and that certain areas should continue to be realms of national autonomy (particularly capital account regulations and the choice of exchange rate regimes). Regional institutions and national autonomy are

particularly important for the smaller players in the international arena, which will gain significantly from competition in the services provided to them and from the maintenance of freedom of action in a context of imperfect supply of global public goods.

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6. INTERNATIONAL FINANCIAL ARCHITECTURE: FOUNDATIONS AND FRAMEWORK

*Gavin Bingham**

1. Introduction and conclusions

The severity and frequency of the financial crises that have enveloped country after country in widely disparate parts of the world in recent years have created a profound sense of dissatisfaction with the current 'international financial architecture'. These crises have caused deep personal suffering and protracted periods of lost growth. They have sown the seeds of social unrest and political instability in a number of key countries.

The purpose of this chapter is to consider what arrangements are best suited for ensuring the efficient and stable operation of the world's financial system. After considering the nature of the changes that have taken place in the international financial landscape since the current arrangements were put in place, it reaches three conclusions. The first is that there is an urgent need for global standards or understandings on sound practices in a broad range of areas, including property rights, procedures for concluding and enforcing contracts, bankruptcy arrangements, accounting, disclosure, supervision and regulation, the design and operation of the safety net and principles for coping with international financial crises. The second is that these global standards

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can best be forged through an inclusive process of building consensus among key players in national markets. Not only does this help to ensure that the standards are relevant for a range of countries, it also helps to promote their rapid adoption. Those who are involved in the development of standards are more inclined to implement them. The third conclusion is that the most effective means of ensuring that standards are adopted is to create clear market incentives that will spur national authorities into action. This approach is complementary to official oversight of internationally endorsed standards, but it is also likely to be more effective since it relies on clear rewards and penalties for action or inaction.

The chapter begins with a discussion of the current international financial architecture and the public goods that it provides. It then describes the dramatic changes in the international financial market that have made it necessary to reform the current architecture; in particular it looks at the questions of volatility, contagion, market integrity and multiple equilibria. Finally, it considers the types of international public goods that are needed in current conditions and considers how they can best be provided.

2. The current international financial architecture

The foundations for the current international financial architecture -the set of arrangements for promoting the efficiency and stability of the international financial system- were laid in the immediate post-war years. At that time financial markets were incapable of intermediating finance, providing risk management services or furnishing liquidity to the extent needed. For that reason international arrangements were put in place to provide a certain basic set of international public goods.¹

The first public good was investment finance for countries that had been devastated by war or had not yet reaped the benefits of economic development. The capacity of the private sector to provide international investment finance had been eroded by the protectionism of the 1930s and the emergency controls of the war years. There was a credible case for the public sector stepping in. To that end the World Bank and the multilateral development banks were established.

The second public good was balance of payments finance. Countries that lacked adequate foreign exchange reserves in a world of fixed parities could easily be tempted to restrict current account transactions, which would impede the development of an open, liberal trading system. Alternatively they might be compelled to adopt draconian adjustment programmes with

1 'International public goods' are those that need to be supplied by sovereign countries acting in concert or by supranational bodies (Samuelson, 1955).

the attendant high economic, social and political costs. In order to avoid these adverse consequences, it was necessary to arrange the public provision of balance of payments finance. The IMF was established to provide it.

The third public good was international economic policy consultation and cooperation. In an internationally integrated world, the policy actions of one country have repercussions on others. Consultation and cooperation help countries to understand each other's policy objectives and to avert inconsistent action. In the early post-war years such arrangements were fairly limited largely because the extent of economic interaction was not very great. In the intervening period, the arrangements have evolved. In particular a number of regional forums have been established, which reflects the intensity of economic interaction between close neighbours. Several international forums, like the G-7, G-10, Apec and Manila Framework, have also emerged. They provide for international interaction among the largest countries and a set of countries in particular regions. However, there is no forum of manageable size that provides balanced representation of systemically significant countries from all parts of the world.

3. The changing international financial landscape

In the decades since the current architecture was put in place, two fundamental changes have occurred in the international economic and political landscape. The first change is the phenomenal growth of international financial markets. The second change, closely allied to the first, is the shift in the relative weight of different countries in the global economic community. These changes have greatly altered the need for international public goods.

There is no single measure that adequately captures the enormous expansion of international financial activity in the post-war period. It started in the industrial countries and then spread to countries that had previously been cut off from participation in the international financial system by poverty, autarkic development strategies or political systems that rejected the logic of market-based economic decisions. Some idea of the increasing size and depth of the international financial market can be obtained by looking at what has happened to international banking assets since 1960. At this time such assets amounted to merely 1.3% of world GDP. By 1997, their share had mushroomed to 37% of world GDP. However, even this dramatic increase understates the expansion of international financial activity, because it fails to capture the emergence of entirely new products and markets as well as the phenomenal increase in turnover of financial assets made possible by advances in information technology.

The expansion of international financial activity has been accompanied by a significant increase in the relative importance of emerging market economies. One indication of this is the change that has taken place in the pattern of reserve holdings (see Table 6.1). In 1960, the ten largest holders were G-10 countries, and they together controlled about 75% of global reserves. By 1997, only four of the G-10 countries ranked among the ten largest holders, which together accounted for only about half of total reserves. Changes in the rankings of countries in terms of GDP have not been as dramatic, but the relative importance of the emerging economies has nonetheless increased.

Table 6.1
TEN LARGEST FOREIGN RESERVE HOLDERS, 1960 AND 1997
(declining order of reserves)

	1960	1997
1.	United States	Japan
2.	Germany	China (PR)
3.	United Kingdom	Hong Kong SAR
4.	Italy	Taiwan
5.	Switzerland	Germany
6.	France	Singapore
7.	Canada	United States
8.	Japan	Spain
9.	Netherlands	Italy
10.	Belgium	Brazil

a) Implications

The expansion of international financial markets has brought substantial benefits. Countries where the rates of return on investment are highest can now tap savings accumulated elsewhere much more easily than in the past. This enables them to grow faster than if they had to rely only on the financing that they generated internally. It also permits investors to reap greater rewards. In addition, it allows both lenders and borrowers to manage their risk in a much more sophisticated manner. And it increases market discipline over economic policies.

Yet at the same time, the emergence of an integrated global market poses major challenges for policy-makers. Volatility, misalignments and contagion are all now serious concerns. The question of multiple equilibria has ceased being a recondite theoretical construct and become a pressing policy concern. But before considering just how the international community should respond to these challenges, let us consider each of them in turn.

b) Volatility and misalignments

Financial markets are prone to rapid and large adjustments.² For example, net private capital inflows into the five Asian countries in crisis jumped from \$41 billion in 1995 to \$99 billion in 1996, allowing these countries to add \$31 billion to their foreign exchange reserves. But when the turnaround came in 1997, it was large and precipitous, amounting to about 7% of their combined pre-crisis GDP and exceeding net official inflows almost threefold. Asset prices are just as likely to move sharply. For example, a dollar- or European currency-based investor who had acquired assets denominated in Indonesian rupiahs in the first half of 1997 would have had four-fifths of his investment wiped out by exchange rate movements alone by spring 1998. The fall in the Indonesian stock market would have cut the remaining value of his investment by another 50% in the three months up to July 1998.

Large adjustments are an innate and desirable feature of the way financial markets work. They stem from the fact that existing claims are actively traded. As a result, changes do not occur only at the margin when new claims are issued. They also occur any time existing assets are bought and sold. The large adjustments in prices and in the pattern of asset holding stand in sharp contrast to adjustment in markets for physical goods and services. In these markets sustainable changes in flows occur only at the margin when new capacity comes on line.

This large and rapid adjustment of the price of financial assets relative to those of goods and services is not simply an idle curiosity. It is an essential part of the process of economic adjustment. The investment needed for economic growth will take place only when the cost of constructing new buildings and acquiring new machines is below the price of the existing stock of capital. Similarly, new investment will be curtailed when it becomes cheaper to acquire the capacity to create goods by buying existing plant and machinery rather than building new ones.³

2 'Excess volatility' does not lend itself to easy definition or precise measurement. Volatility is often gauged using statistical measures of time series of differing frequency and a distinction is sometimes made between short-term volatility and medium-term misalignments. Short-run volatility measured using high frequency data has shown no tendency to increase. Indeed in some cases, for example in the case of covered interest rate differentials, volatility has come down as the costs of arbitrage have fallen. However, 'fat-tail' swings -exceptional events at one extreme of the probability distribution- can have real effects when they exceed certain thresholds and, for example, consume a bank's capital, thereby forcing it into liquidation. Most of the concern has been focused on the longer-term swings in asset prices that generate misalignments. If sustained, these longer-term misalignments may have significant real effects.

3 The current market value of the existing capital stock in terms of the cost of producing new capital goods is sometimes referred to as Tobin's Q after James Tobin, who pioneered the concept (Tobin, 1969).

While there is a good economic case for large swings in financial asset prices and the accompanying volatility in financial flows, it would be folly to claim that all volatility is benign. On occasion manias and bouts of investor euphoria lead to asset price bubbles. They occur because markets are not only driven by 'fundamentals' -the discounted present value of the future income generated by the asset- but also by the expectation of profits that can be made by buying cheap and selling dear. It is not necessary to know the 'intrinsic' or 'fundamental' value of the financial asset in order to make a profit; all that is needed is to find a counterparty who is willing to purchase the asset at a higher price. Because many trading and investment decisions are made on the basis of extrapolative expectations or technical analysis and because there is considerable uncertainty about underlying fundamental values, it may be perfectly rational to buy an asset at a high price as long as there is the firm expectation that it can be sold at a still higher price.

c) *Contagion*

'Contagion' is a term that has been used to describe the spread of economic distress from one country to another. In some cases the channels of transmission are real. In these cases, troubles can spread because several countries face similar problems such as weakness in demand in export markets or the 'softness' of commodity prices. In other cases the channels of transmission will be financial. For example, a reduction in risk appetite or a re-assessment of the prospects for one member of a certain class of borrower may lead investors to readjust their entire portfolio, often using the market instruments that are the most liquid. Countries sometimes then experience the ebb and flow of capital even in the absence of any change in their own underlying economic conditions. It is often difficult to disentangle real from financial contagion because of the self-reinforcing nature of the interaction between the real and the financial sectors.

In understanding financial contagion, it is important to note three features. The first feature is that it reflects rational behaviour on the part of investors, desiring to re-balance portfolios in the face of a shock. The second feature is that it is generally the weaker economies that succumb to the adverse effects first, just as the infirm are most likely to be infected by a contagious disease. The third feature is that in a highly integrated global financial system, even the deepest and most liquid markets are not immune from events occurring elsewhere. The very substantial reduction in risk appetite that led to the troubles in Long Term Capital Management (LTCM, see Chapter 7 in this volume) was partly the result of the debt moratorium by Russia in August 1998.

d) *Market integrity*

A new challenge posed by the huge expansion of the global financial market is maintaining market integrity. This involves seeking to ensure that sudden and unexpected shifts in risk appetite or a sharp reduction in leverage do not have adverse consequences on the real economy by making key financial markets illiquid. It also entails seeking to ensure that pricing is not distorted as a result of the asymmetry between the amount available for investment and the size of individual markets. It is not uncommon for a single financial institution to have well over \$100 billion under management. Yet the total capitalisation of markets in the currencies of some emerging markets is only a small fraction of this. In these circumstances, concern about actions by a small number of large investors is understandable.

e) *Multiple equilibria*

Multiple equilibria have become of greater policy concern because of the greater depth and sophistication of the financial markets. The interaction between the real and financial sectors has become closer and more complex. As a result, there is a greater risk that a country will be pushed from a 'good' equilibrium to a 'bad' one.

A good equilibrium is one where financial and real developments reinforce one another. For example, capital inflows may enable a country to undertake productive investment that generates the income needed to service the debt. The confidence of creditors in the capacity of the debtors to service their debt will allow the country to continue to borrow in the market, to undertake further investment, to finance a current account deficit, to keep the exchange rate at the current level and to continue to grow. Increasing liquidity in the financial market will provide investors with the confidence that they have access to their funds whenever they wish. There will be a degree of leverage in the economy and this equilibrium will be sustainable indefinitely.

By contrast, if some event, whether at home or abroad, causes investors to re-adjust their portfolios, a vicious circle of capital outflows, reduced liquidity in the financial market, higher financing costs, exchange rate depreciation, debt default, bank failures and a further contraction in lending that reduces investment may thrust an economy into a 'bad equilibrium'. There will be very low leverage because banks and other borrowers will not be willing to lend, and very little liquidity because transactions in financial instruments will be severely curtailed.

There is no simple answer about how to maintain a good equilibrium and to avoid a bad one in a globally integrated environment. This is because the outcome depends both on events and conditions that national authorities can control or influence and on events outside their control, such as developments

in markets on the other side of the world. The prospect of shocks from unexpected quarters make it essential to make economies robust through the pursuit of consistent economic and structural policies that enhance the capacity to adjust and to withstand large and unexpected shocks. One element of such a strategy is an overall debt management strategy that focuses on maturity and exchange rate risk.

4. Consequences for the provision of international public goods

The phenomenal growth of financial markets has had a number of implications for the supply and demand of international public goods. Put starkly, the supply of these goods does not correspond to the demand. As was mentioned above, the current international arrangements are basically designed to supply investment finance, balance of payment finance and arrangements for policy consultation.

Today, most countries can obtain the funding they need from the international financial market. Indeed, some would contend that it is the very abundance of funds, not a shortage, that is the problem since ample availability may permit countries to make ill-considered and possibly even reckless economic policy decisions. To be sure, there are some highly indebted or very poor countries that do not have normal access to markets, and at times of crisis even successful middle-income countries can find themselves effectively shut out from international capital markets. But for the vast majority of countries, the provision of balance of payments and development finance has been privatized.

Moreover, the arrangements for consultation and international policy dialogue are inadequate because they do not allow important emerging market economies to participate as full partners. This is because existing groupings were created at a time when these countries were less important. A way needs to be found to allow them to participate as full partners in the development of the 'rules of the game' for a robust international financial system.

a) *The new public goods*

In the financial conditions that prevail today, three new public goods are needed. The first such good are arrangements to generate comprehensive and effective rules applying across the board to all who partake in the globally integrated financial system. Without such rules, there is the danger that incompetence, fraudulence or imprudence in one part of the system will create disruption or even havoc elsewhere. A set of sound practices or a code

of good behaviour is important not only for the efficiency and stability of the international financial system. It is also necessary to ensure a level playing field and equitable treatment of market participants from diverse constituencies.

The second international public good that is needed is a mechanism to ensure that sets of sound practices are implemented. Without concrete action to ensure that sound principles are followed, the codes of conduct remain pious pronouncements devoid of any practical meaning.

The third public good is an effective means for crisis containment and resolution mechanism, relying to the greatest extent possible on private sector action. No matter what is done to strengthen the international financial system, crises will continue to occur. Some would contend that this is not merely inevitable but even a blessing in disguise. Risk is inherent in financial activities, and if systems were made completely risk-proof, markets would become lax and fail to reward those that did the most to strengthen their risk management capabilities. They might also cease to generate Schumpeter's 'creative destruction', that leads to the replacement of outmoded technologies by new ideas and better processes (Schumpeter, 1942).

b) Designing standards

The first question to be addressed is: What sort of standards do we need and how can they best be developed? It would be far too ambitious to specify in detail the specific nature of the standards that are needed. This would be tantamount to writing the standards which, for reasons set out below, should be done through an international process of consultation. However, it is useful to delineate areas where standards would be helpful.

Sets of sound practice are needed in three basic areas. The first is what may be termed the infrastructural underpinnings of financial markets. The second relates to the conduct of macroeconomic policies conducive to stability. The third concerns understandings on how to cope with stress in the financial system. The three areas are not completely independent: having good insolvency regimes helps, for example, in coping with stress in the system.

In the area of infrastructural underpinnings it is useful to have understandings on how market participants can credibly conclude contracts and have recourse to effective legal or other remedies in the event the contract is not honoured. They also need to have means to discharge contracts in the normal course of events; in other words, there needs to be a robust payment and settlement system. Reliable and accurate accounting and auditing practices are also needed. The regulatory arrangements should be effective, impartial and designed to correct moral hazard or to compensate for

distortions in incentives. Finally stakeholders need to exercise effective oversight over the entities in which they have an interest. This entails both good corporate governance by shareholders and effective risk management by lenders and investors.

In the area of macroeconomic policies, it is not feasible to develop concrete standards because alternative policy combinations will produce positive results. What is important is the consistency among the various components. Here, transparency is essential. Standards of transparency in fiscal and monetary policy will help to ensure that policies are consistent and that the fiscal and monetary authorities are accountable.

A third area where understandings on sound practice are needed is in dealing with financial and economic distress in national economies. This entails designing financial and social safety nets that act both to prevent severe disruption in times of crisis and to foster rapid return to economic health. It requires insolvency arrangements that are fair and effective not only in design but also in practice. It requires a set of credible, limited guarantees that prevent bank runs and maintain liquidity in troubled times. It requires arrangements for early, rapid and structured intervention by the authorities as the health of financial institutions deteriorates. And it involves setting priorities for social expenditure at times of crisis. All these arrangements must be designed and implemented in a way that minimizes moral hazard. Having understandings on sound practices in these areas will help countries respond rapidly to crises and will alleviate distortions arising from widely differing practices.

It is easy to call for global standards and understandings on best practice. Developing them in a way that ensures that they are widely accepted and effectively implemented is more difficult. The standard development process must meet two criteria for the codes to be useful. First, understandings on codes must be reached in an international process that is consultative. Ideally the process should draw on the best expertise available in key national markets. Moreover, the process should be inclusive and involve a wide range of countries. Not only will this ensure that new ideas are brought to the table, it will also help to ensure commitment to the standards. Ownership is essential because in the end it is the national authorities that implement the standards, and national authorities will be much more inclined to take action if they feel that they have helped to shape the international standards.

A second important feature of a good set of standards is that they should be precise and operational. High-sounding 'motherhood' principles, no matter how intellectually appealing, are of little import. They must be complemented by concrete standards that determine what actions need to be taken.

c) Implementation

Securing observance of internationally agreed standards needed for the efficient and stable operation of the international financial market is as important as developing the standards themselves. Indeed, without meaningful implementation, the proclamation of standards can cause more harm than good. It can lull the international community into a false sense of security. In addition to including the countries to which the standards will apply in the process of developing the standards, there are three basic ways to foster implementation: encouraging markets to price the risk associated with non-compliance, using market access as a carrot and incorporating the evaluation of compliance into international surveillance and technical assistance programmes.

Market discipline is the single most effective way to secure observance of standards. Markets are stern taskmasters. But by the same token, they provide concrete rewards when actions are taken to strengthen financial markets. Risk premia are reduced and borrowers are able to tap international financial markets at lower cost.

Markets, however, will not provide the externality of effective oversight of the observance of standards unless certain basic preconditions are met. The first precondition was already mentioned: having standards that are concrete and precise enough so that it is easy to determine whether or not they are being observed. The second precondition is having sufficient information on the conditions in the country to make this judgement. Transparency helps to ensure that this information is available. In cases where the standards must be more general and careful judgement is needed, a mechanism for evaluating observance needs to be developed. This can be market based through credit rating agencies or it can take place through international financial institutions (IFIs) that conduct surveillance and then make their findings known.

Access to major financial markets vies with market discipline as the strongest incentive for implementation. Today the authorities in some major markets make observance of certain minimum standards (e.g. consolidated supervision), a condition for market entry. If wide international consensus were reached on the necessity for observance of key international standards, their spread would be speeded greatly.

Finally, monitoring and technical assistance from the IFIs can promote adherence to standards. Evaluation of adherence could be incorporated into regular consultations or made a standard element in the conditions attached to international programmes. Releasing the findings of the surveillance exercises enhances the leverage of the IFIs, but quiet cajoling may sometimes be more effective.

d) *Crisis management*

The final international public good that the new international architecture needs to provide is improved crisis management. Current arrangements are designed to provide official funds in times of stress. While it is important to ensure that a shortage of liquidity does not lead to a vicious circle that moves a country from a good equilibrium to a bad equilibrium, this does not necessarily imply the use of large amounts of official financing. Funds are, in principle, available in ample amounts in the market. The challenge is to ensure that they are *mobilized*. This requires developing principles and procedures that enable creditors and debtors to work together when unforeseen circumstances make it impossible to meet the original terms and conditions of a contract. There is no single method that is best suited for resolving each crisis, and the principles will need to allow for the specific circumstances prevailing at the time. The arrangements should exploit the availability of finance from the financial market but ensure that the underlying problems are resolved quickly and effectively.

Conditions linked with the provision of finance can help to ensure that the policies giving rise to the problems are corrected. Bilateral creditors may seek to impose conditions that suit their own interests and agendas. Policy advice that is provided in a multilateral context is much more likely to be impartial. For this reason, it is best to formulate conditions in a multilateral setting, in a neutral and impartial manner. It is useful to note that there may be a trade-off between the neutrality of the policy advice and the size of exposure. While those that devise and apply the conditionality may need to provide some funds so that the creditors pay heed to the advice, the amounts made available by the international official sector should be kept modest.

In sum, what the new architecture should provide is a set of universally accepted principles and practices that are developed by national authorities through an inclusive process of consensus-building. These principles and practices should be concrete enough for markets to be able to reward those who observe them. In the event that crises occur, debtors and private creditors should work together to resolve the problems. Conditionality, however, should be provided in a neutral and impartial manner by the international community.

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7. THE NEW GLOBAL FINANCIAL LANDSCAPE UNDER STRESS*

*Hans Blommestein ***

1. Introduction: benefits and challenges of the new global financial landscape

The forces shaping the revolution in banking and capital markets have radically changed the new financial landscape (Blommestein, 1995, 1998a). A remarkable feature of this changing landscape has been the astonishing rate of internationalisation of the financial system in the last two decades or so (Figure 7.1).

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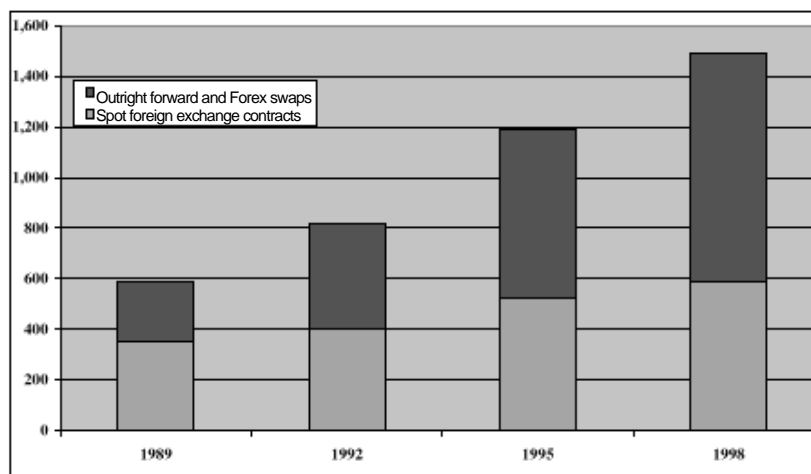
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Dramatic changes in computer and information technology, advances in the theory of finance during the past 25 years, and new financial product and market designs, have made world financial markets far more efficient than ever before. The new global financial landscape enables an ever wider range of financial and non-financial companies, as well as individuals, to manage risks more effectively. This more efficient allocation of risk, driven by the incentive to equate risk-adjusted rates of return on investments globally, has led to a strong increase in the creation of value and standards of living.

Figure 7.1

SUMMARY OF GLOBAL ACTIVITY IN FOREIGN EXCHANGE MARKETS *

(average daily turnover in billions of US dollars)



Source: BIS.

* Adjusted for local and cross-border double-counting ("net-net"). Includes estimates for gaps in reporting.

Innovations in financial-contracting technology (futures, options, swaps and other contractual agreements) have played a central role in this development by expanding the opportunities for risk sharing, lowering transaction costs and reducing information and agency costs (Merton, 1998). The extraordinary growth in the use of derivatives (Scholes, 1998) and the huge proliferation of new financial products and markets, have made possible the creation of an increasing number of layers of financial intermediation to capture the benefits of advances in finance (Greenspan, 1997).

This financial globalization process has both enhanced cross-border trade in goods and services and facilitated foreign direct investment flows and the implementation of cross-border portfolio investment strategies (Greenspan, 1997). Merton (1998) notes in this context that derivative-security contracting technologies have played a vital role in this process by ‘adapting’ and offsetting dysfunctional institutional rigidities in national financial systems that are not entirely compatible in terms of regulations, institutional forms, tax regime and business practices. At the same time, it has been argued that the increase in the more efficient functioning of financial markets has been accompanied by the increased likelihood of significant market disruptions. The new global financial landscape is capable of transmitting disturbances or mistakes at a far faster pace throughout the world economy than before (Greenspan, 1997). Consequently the increase in systemic risk poses new challenges for financial policy-makers.

The dynamics of the financial crises in 1997–98 highlights in a dramatic fashion that a truly new *global* financial landscape has emerged. However, the crisis also raises fundamental questions about the benefits of the new global financial system. In particular doubts have been expressed about the benefits for emerging markets, but also for mature financial systems, to integrate into the world financial system, as the likelihood of systemic crises has increased. Finally, and quite unfortunately, the most serious global financial crisis of the last 50 years¹ and the associated volatility and liquidity problems are far from understood.

This chapter suggests the beginning of some answers to questions that have been raised against the backdrop of the turmoil in the global financial landscape. Policy suggestions are also made as to how best to deal with the problems in the new global financial landscape.

2. Dynamics of the global financial crisis: the dramatic events in financial markets in 1998

a) The threat of a systemic collapse

Conditions in international financial markets had shown signs of stabilizing earlier in 1998, but a new wave of turbulence emerged in mid-summer, affecting Russia and, to a lesser extent, other Eastern European countries and Latin America. Russia’s debt moratorium and effective default brought about a dramatic shift in investors’ attitudes towards risk, characterized by flights to quality and eventually to an almost unprecedented

¹ A characterization used by former US Secretary of the Treasury Rubin and many others (see Rubin, 1999).

preference for liquidity. Losses in Russian markets and a dramatic widening of risk premia led to successive waves of selling in emerging market assets. Initially, the generalized flight to quality favoured government securities in OECD countries, contributing to lower nominal long-term interest rates and to higher equity prices. However, in mid-September the flight to quality became more severe and financial markets in some OECD countries began to be adversely affected as well, starting with swaps and credit spreads and eventually encompassing equities. The Federal Reserve-brokered private-sector rescue of US hedge fund Long Term Capital Management (LTCM) was a defining moment in the financial turmoil in 1998, reflecting serious concerns that a sudden default of LTCM would lead to a fire sale of its assets, sufficiently intense and widespread that there was a chance of a systemic collapse.

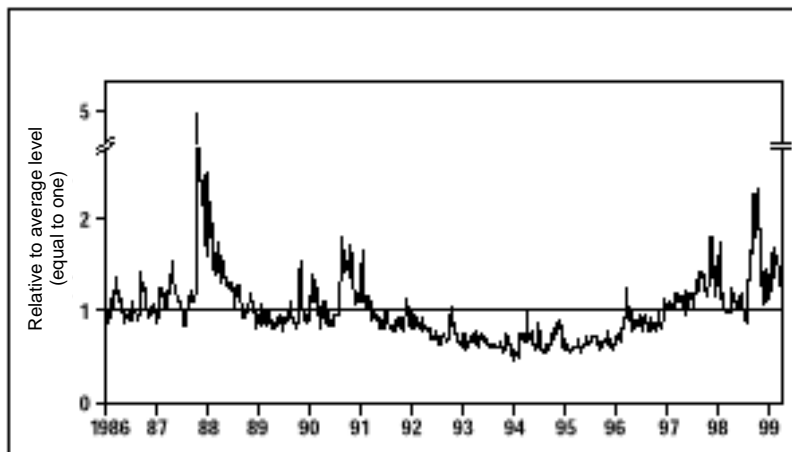
b) Exceptional financial market uncertainty

These extraordinary events in the global financial landscape in the summer and autumn of 1998 manifested itself in several ways. Stock prices fell sharply in the period 17 July–end of August, prices and issuance of quality commercial paper dropped, the value of bonds in emerging markets fell and there was a strong flight to only very safe assets.

The shift in preferences toward safe assets led to increases in *quality spreads* among corporate bonds. Large quality spreads and flight to quality reflect heightened *repayment (or credit) risks* across the board. This general financial market uncertainty is different from increased doubts by the market

Figure 7.2

CHICAGO BOARD OPTIONS EXCHANGE
(volatility index)



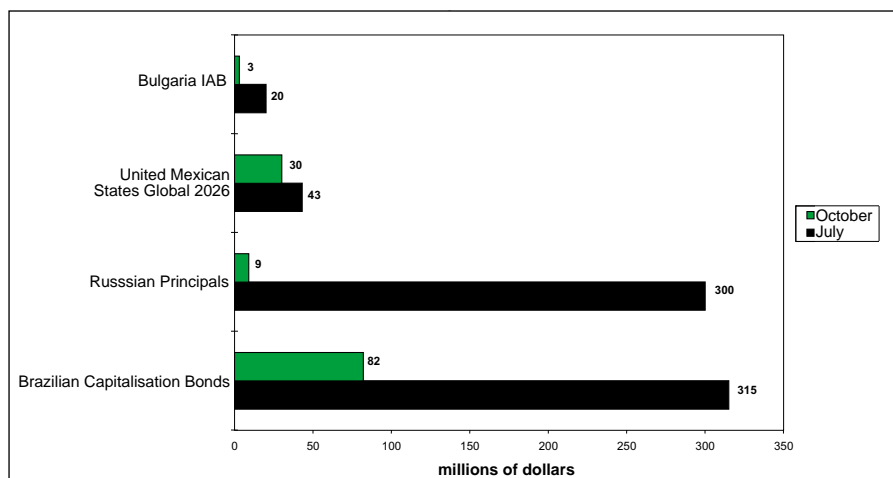
Source: CBOE

about the earnings potential of corporations. A good indicator of general financial market uncertainty is the volatility index based on option contracts on the S&P 100 index. Figure 7.2 shows the dynamics of financial market uncertainty across time. Uncertainty increased strongly after the October 1987 stock market crash, the Gulf war in 1990-91, the Russian crash and the LTCM débâcle in August-September 1998, and the Brazilian devaluation in January 1999.

c) *The flight to liquidity*

Investors, meanwhile, were unwilling to invest, especially in assets perceived to carry any credit risk, even at the generous spreads that were being offered. The downward pressure on asset prices was exacerbated by the unwinding of positions by hedge funds and other highly leveraged investors. The volume of financial paper for sale included assets held by LTCM and other large hedge funds. The combined effect of all these forces was a sharp drop in trading in many categories of risky assets, as liquidity essentially dried up (see Figure 7.3), the prospect that led the Federal Reserve to lower its target for the federal funds rate by 25 basis points on two occasions, in late September 1998 and mid-October. In the wake of the Fed's actions, market sentiment improved somewhat. Central banks in a number of other OECD countries also lowered their official rates. Official rates were reduced in Denmark, Ireland, Italy, Portugal, Spain, Sweden and the United Kingdom.

Figure 7.3
DAILY TRADING VOLUME



Source: Euro Brokers, Salomon Brothers.

d) *Tightening of credit conditions*

Concerns that the deteriorating conditions in international financial markets and investor flight to quality would lead to an across-the-board credit crunch appear to have been tempered somewhat by the moves to trim official interest rates. Global equities rallied from the lows reached in early October, and a moderate amount of new issues of lower-rated corporate and emerging market sovereign bonds were successfully brought to market. The extent to which the turbulence in financial markets affected credit availability in 1998 varied considerably across regions. In Asia, where the financial crisis first began in 1997 and where problems with non-performing loans have been most pronounced, the degree to which credit was tightened was generally more severe than in other areas. In Japan, for example, bank lending continued to decline in the face of rising corporate bankruptcies and declining earnings. The contraction in bank credit caused a number of corporate borrowers to turn to the bond market for funds. However, with corporate bankruptcy rates holding at record levels, access to the bond market for corporations other than the triple-A rated utilities was limited, especially for companies with credit ratings below single-A.

As opposed to Asia, the tightening of credit availability in the United States in the wake of the LTCM débâcle largely took place via the capital markets, as reflected in the virtual shut-down of the market for high-yield bonds. Although concerns about the risks of a credit crunch were much less pronounced in Europe than in the United States (attributed to the cushioning influence of relationship banking in Europe), reports indicated that the leveraged loan market in Europe also experienced a drastic fall-off in liquidity.

3. The need to understand better the new financial landscape and its impact on financial crises

a) *The new financial landscape: increasing complexity*

As indicated in the Introduction, the structural changes in the past 25 years have enabled a broad unbundling of risks through innovative financial engineering. These changes have resulted in very complex financial products and markets. Common stocks and debt obligations have been augmented by a vast array of complex hybrid financial products, which allow risks to be better allocated and priced. Although these hybrids enable in principle a more efficient allocation of risk, at the same time they have led to an increase in complexity. Even sophisticated market participants might have difficulties understanding the nature of these new products and markets. Consequently, risks may be seriously mis-priced, and these mistakes may unfortunately emerge only when markets are subject to major external shocks.

The dynamics of the new financial landscape have changed with an increase in the pace of financial innovations, a rapid expansion of cross-border financial transactions, the faster pace of transmitting shocks or mistakes throughout the international financial systems and greater sensitivity on the part of financial market prices to changes in preferences. This change in dynamics is part of, and contributes to, the increase in complexity of the new financial landscape.

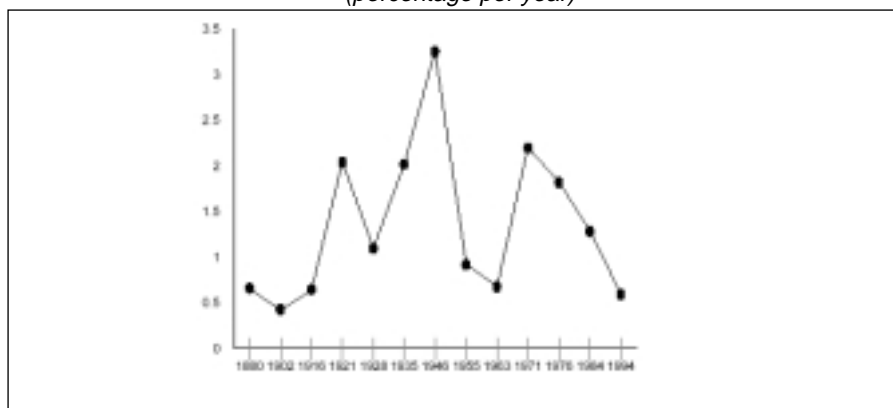
The growing importance of derivatives for risk management and the leveraging of investment positions is a driving force behind the stronger and more complex links between cash and derivatives markets. The blurring of sectoral and product boundaries is also adding to the complexity of financial intermediation. This complex, multilayered intermediation system is better able than before to not only reward innovation, productive investment and sound public policies but also to more harshly discipline the mistakes of private investors and public policy-makers.

b) How different is international financial integration today from earlier periods with a high degree of integration?

In order to gain a deeper understanding of how 'new' the new global financial landscape actually is, it is instructive to compare the current financial system with that of earlier periods with a high degree of international financial integration. The period 1870–1914 and, to a lesser degree, 1925–31, were characterized by high capital mobility. Although capital mobility has

Figure 7.4

STANDARD DEVIATION OF RETURN DIFFERENCE
(percentage per year)



Source: Obstfeld (1998).

Note: On the y-axis is the standard deviations of the difference between rates of return on short-term financial assets sold in London and New York

significantly increased since the Second World War, the current financial landscape is not characterized by an unprecedented degree of capital mobility (Obstfeld, 1998 and Figure 7.4). According to Figure 7.4, only in the 1990s would capital mobility have reached the level of the period 1890–1914.

Thus, increased mobility is not the key characteristic that uniquely defines the new financial landscape. Today's global financial system differs from the earlier period of high capital mobility in the form of the following key distinctive features:

- i) *A much wider array of financial instruments: innovations and a dramatic increase in securities-related activities*

In all OECD countries financial intermediation through the securities markets gained in importance, and this rapid development is likely to continue in the 21st century. An important structural change that encourages the development of securities-related activity concerns the demand of investors for a broad range of assets with different risk–return characteristics. This in turn has led to a marked acceleration in the creation of asset-backed (ABS) and mortgage-backed securities (MBS) (Table 7.1). Securitization plays a key role in (re)packaging and (re)selling risks, including insurance liabilities (Cecchetti, 1999).

Table 7.1
ABS/MBS TRANSACTIONS, BY COUNTRY, 1997

Country	US\$ (billion)
International ^a	32.34
United Kingdom	23.84
France	11.44
Netherlands	6.80
Australia	3.65
Japan	3.19
Belgium	1.54
Hong Kong	0.98
Italy	0.90
Switzerland	0.70
Spain	0.65
Indonesia	0.49
Brazil	0.28
Peru	0.25
Mexico	0.20
Canada	0.17
Turkey	0.12
Argentina	0.11
Thailand	0.08
Germany	0.03
Total	87.75

Source: IFR Newsletters, International Securitization Report.

^a Includes issues that are denominated in a currency other than the sponsor's home currency and are sold abroad.

This securitization trend would be also strengthened by the desire of banks to bring the size of their balance sheets under better control. At present, this technique is widely used in only a handful of OECD countries and, therefore, there is a vast potential for an expansion of securitization throughout the OECD area.

The markets in derivative products are likely to expand at least as fast as the underlying cash markets. Derivative instruments are major tools for the management of risk by market participants, in particular the larger professional investors, and they will continue to be both an indispensable complement and substitute for cash markets. In both cash and derivative markets, the traditional exchanges are likely to be challenged by alternative systems for trading, including the over-the-counter (OTC) markets (Table 7.2).

Table 7.2
MARKETS FOR SELECTED FINANCIAL DERIVATIVE INSTRUMENTS
(in billions of U.S. dollars)

Instruments	Notional amounts outstanding at end-year					
	1992	1993	1994	1995	1996	1997 ^a
Exchange-traded instruments	4,634.5	7,771.2	8,862.9	9,188.6	9,879.6	12,207.3
Interest rate futures	2,913.1	4,958.8	5,777.6	5,863.4	5,931.2	7,489.2
Interest rate options ^b	1,385.4	2,362.4	2,623.6	2,741.8	3,277.8	3,639.9
Currency futures	26.5	34.7	40.1	38.3	50.3	51.9
Currency options ^b	71.1	75.6	55.6	43.6	46.5	33.2
Stock market index futures	79.8	110.0	127.7	172.4	195.9	216.6
Stock market index options ^b	158.6	229.7	238.4	329.3	378.0	776.5
OTC instruments ^c	5,345.7	8,474.6	11,303.2	17,712.6	25,453.1	28,733.4
Interest rate swaps	3,850.8	6,177.3	8,815.6	12,810.7	19,170.9	22,115.5
Currency swaps ^d	860.4	899.6	914.8	1,197.4	1,559.6	1,584.4
Interest rate options ^e	634.5	1,397.6	1,572.8	3,704.5	4,722.6	5,033.1

Source: BIS

^a For OTC instruments, end-June 1997.

^b Calls and puts.

^c Data collected by ISDA only, the two sides of contracts between ISDA members are reported once only.

^d Adjusted for reporting of both currencies; including cross-currency interest rate swaps.

^e Caps, collars, floors and swaptions.

ii) *Changes in market volatility, contagion and market discipline*

The *sensitivity of market* responses under the new regime has been underscored by the startling declines of exchange rates of some emerging market economies against the dollar, and most other major currencies, of 50% or more in response to what at first appeared to be relatively modest problems and/or underlying economic weaknesses (Table 7.3). Also periods with extreme stock market volatility seem to have become more frequent (Figure 7.2).

Table 7.3
INTEREST RATES AND THE EXCHANGE RATE DURING THE CRISIS

	Interest rates					Exchange rate	
	Overnight rate		Three-month rate			Low ^a between July 1997 and March 1998	
	Peak	Date	1st half 1997	Peak	Date	Depreciation ^b	Date
Hong Kong	100.0	23.10	5.8	25.0	23.10	0	-
Taiwan	11.5	7.10	6.1	9.8	7.10	-19.3	12.1.98
Indonesia	300.0	25.8	13.7	27.7	31.10	-84.3	23.1.98
Korea	27.1	30.12	12.7	25.0	23.12	-54.6	23.12
Malaysia	50.0	10.7	7.2	8.8	20.11	-46.3	8.1.98
Philippines	102.6	6.10	14.0	85.0	8.10	-41.8	7.1.98
Singapore	50.0	23.10	3.6	10.3	10.12	-21.0	12.1.98
Thailand	27.4	5.9	13.1	26.0	25.12	-55.0	12.1.98

Source: BIS.

Note: Dates refer to 1997 unless otherwise indicated.

^a Closing rate.

^b Percentage change in the US dollar/local currency rate since June 1997.

These violent moves in exchange rates and other financial asset prices are *prima facie* indications that market discipline appears far more draconian than 20 or 30 years ago.

Contagion seems stronger and, in part also different, than in earlier periods. The new global financial landscape is capable of transmitting disturbances or mistakes at a far faster pace throughout the world economy than before. The globalization of finance has resulted in an unprecedented number of financial institutions that are active internationally, highly leveraged and, in many cases, using new financial technologies and instruments. Rapid and widespread re-assessment and re-pricing of financial risks are further accompanied by de-leveraging and re-balancing of global portfolios, resulting in extreme price movements in markets around the world. For these reasons, *traditional* contagion channels, such as trade links and world interest rates, do not explain fully the contagion in 1998 after the Russian and LTCM events. The increase in correlation in spreads seems to point at the increasing importance of *financial* contagion.

iii) *Increased competition*

The competition for capital has increased dramatically, both in national markets and globally. As a consequence, investment projects and public policies are more strictly scrutinized, and this capital, in times of stress, also flees more readily to securities and markets of high quality and liquidity. The

new financial landscape is defining *a more competitive beauty contest among countries and markets*, with greater rewards for good policies and projects but also greater punishments for mistakes.

Such competition has increased strongly as a result of the following structural forces:

- the removal or weakening of barriers to entry
- the liberalization of diversification activities
- the removal or reduction of restrictions on ownership structures
- globalization of business activities
- innovations and technological advances (e.g. electronic trading).

Increased competition has resulted in the lower cost of financial services and an increase in the expansion of the range and quality of financial services, often offered on the Internet at relatively low cost and relative ease.

Institutional manifestations of the increase in competition have been the growth in the number of financial conglomerates (i.e. a blurring of traditional sectoral boundaries –banking, insurance, asset management, security market operations), the blurring of the boundaries between products, and changes in distribution channels (Briault, 1999).

This trend of increased competition has put additional pressure on the profitability of the brokerage business. As a result of these trends, the major intermediaries are likely to de-emphasize secondary market brokerage activities. Instead, they seem to focus more on proprietary trading in both cash and derivative markets, by temporarily taking large net positions using the institution's own capital and often employing highly leveraged investment strategies. In pursuing this strategy, the intermediaries are in many cases opting to deal in the lower-cost, less-regulated environment of OTC markets rather than trading on the exchanges.

iv) *Highly leveraged investment strategies and financial markets*

A key feature of the new financial landscape is the higher leverage of financial institutions in comparison with earlier episodes, and the ease, low cost and rapidity in which leveraged investment positions are being built up. Financial institutions use a number of techniques to achieve leverage, including the use of repurchase agreements (repos) and swaps, options, futures and other structured products. Of these instruments, repos are perhaps the biggest source of secured funding, but derivatives contracts are also used extensively to boost leverage.

Most hedge funds use derivatives as sources of both liquidity and leverage. For the large, global-macro funds, whose sheer size makes liquidity of paramount importance, their use of derivatives in some markets is focused primarily on liquidity rather than on leverage *per se*. The hedge fund sector is

far less leveraged, on average, than other parts of the financial services sector (Lumpkin and Blommestein, 1999). However, other parts of the financial sector –e.g. commercial and investment banks– are typically higher leveraged than the ‘average’ hedge fund (Table 7.4).²

Hedge funds, with higher performances for risk than some other market participants, are important participants in the new financial landscape because they contribute to a more efficient allocation of risk. In addition, hedge funds provide liquidity and their trading activities also promote price efficiency.

Table 7.4
LEVERAGE RATIOS FOR SELECTED INVESTMENT BANKS

Firm	Assets (billions)	Equity (billions)	Leverage ratios ^a	
			Gross	Net ^b
<i>Merrill Lynch</i>	365.45	11.47	31.9	18.9
<i>Morgan Stanley Dean Witter^c</i>	359.58	10.66	33.7	14.8
<i>Lehman Brothers</i>	179.07	5.08	35.2	19.8
<i>Donaldson, Lufkin & Jenrette</i>	79.56	2.74	29.0	12.3
<i>Paine Webber Group</i>	63.97	2.56	25.0	10.0

Source: Salomon Smith Barney.

^a Leverage ratio calculated at mid-year 1998.

^b Excluding ‘matched-book’ financing.

^c Excludes credit-services operations.

c) Financial crises appear different than before

The crises that have emerged out of this new, complex financial structure appear different in important ways. At the same time, despite all the structural changes since the earlier period of high capital mobility,³ the potential sources of cyclical variability in capital flows remain the same: divergent macroeconomic conditions in capital-exporting and capital-importing countries, and crises in individual capital-importing countries (IMF, 1997). Consequently, it is not *a priori* clear whether recent crises are deeper than in the past, or just triggered more readily. As noted above, the new financial

2 These institutions also tend to make much greater use of derivatives to leverage their bets than the typical hedge fund. It should be noted, however, that this particular measure of leverage is not very refined, as it ignores the nature of underlying securities.

3 The earlier period refers to 1870–1914 and the 1920s.

system has the capability to rapidly transmit the consequences of errors of judgement in private investments and public policies around the globe at historically unprecedented speed. In contrast to earlier contagion or crisis periods, the form and structure of global finance had, and are having, a major impact on the dynamics of more recent crises. Nonetheless, these features do not sufficiently explain the severity of financial market turmoil in the last five years or so.

The Mexican crisis of 1994–95 can be characterized as the first crisis of this new international financial system, preceded perhaps by the 1992–93 ERM crisis and the generalized turbulence in 1994 in the major OECD bond markets. The crisis that started in East Asia in July 1997 is its second. The Russian crisis of August 1998 is the third, while the rescue of LTCM in September 1998 can also be considered as another defining moment in the manifestation of extraordinary financial turmoil in the global financial landscape.

The Mexican crisis had many of the weak fundamentals of earlier financial crises, primarily a very large current account deficit and a vulnerable external debt profile.⁴ Also many of the more recent crises, from Thailand to Russia, have similar conventional causes -fiscal and trade imbalances, and/or imprudent borrowing denominated in foreign currencies. But the size of the decline in the growth of output, the intensity of the disruptions and certainly the size of the financial rescue operations, seemed larger relative to the underlying causes than comparable previous episodes.⁵ This is especially the case when we consider how outsized, for example, the distortions were in Latin America in the early 1980s, relative to not only the size of the financial rescue packages but, even more so, to the time-frame of the various initiatives to resolve the Latin American debt crisis.⁶

4. Policies for now and the future: actions and challenges in the new financial landscape

Since the Mexican and Asian crises, policy-makers have been forced to engage in an accelerated learning process of how to deal with and/or to prevent crises in the new financial landscape. The LTCM débâcle reinforced this point in a

4 Current account deficits as a percentage of GDP and the ratio of short-term external debts and reserves were lower in the most recent financial crises in Mexico and Argentina than in the 1980s (see Table 2 in Kamin, 1999).

5 Garry Schinasi concludes that also the recent turbulence in *advanced* financial markets appeared out of proportion to the events that triggered it (see Schinasi, 1999).

6 The Latin American Debt crisis of the 1980s started with the default of Mexico in 1982 followed by various rescue plans or initiatives as part of the so-called evolving international debt strategy (Cline Plan, Baker Initiative, Brady Plan). See Blommestein, Dittus and O'Brien (1991).

dramatic fashion. There are serious disagreements among policy-makers and market participants, often related to the fact that the dynamics of the new financial system and its ramifications for financial institutions and policies *are not fully* understood, and this generates a fair amount of uncertainty. Nonetheless, some answers in key policy areas are emerging.

a) *Institutional preconditions to sound financial markets: linkages between banks and capital markets*

A key insight for financial policy-making is based on the very practical and analytical considerations of the relationships between banks and securities markets and of how to ensure that the financial system intermediates funds as efficiently as possible, accepting that informational asymmetries cannot –indeed, should not always– be eliminated. As an antidote to the argument that banks and securities markets can be developed independently –so that, for example, if the banking system is rife with problems, securities markets can be developed to replace banks as a source of capital– it should be noted that securities markets generally depend upon banks to provide key services (Blommestein and Spencer, 1994, 1996). In many countries, banks or their subsidiaries act as brokers or dealers in which case the link between securities firms and banks is very direct.

i) *Soundness of the banking system*

A fundamental problem concerns the financial fragility of the banking sector, caused by the legacy of bad assets and the concentration of risk with relatively few large borrowers on the one hand and the low level of bank capital on the other. This situation may worsen as long as the causes of moral hazard (i.e. implicit or explicit deposit insurance and asymmetric information) are not eliminated, while inadequate supervision may enable the banks (and their customers) to exploit the existence of moral hazard.

Major factors hampering the effectiveness of banking supervision include the lack of reliable information about the financial condition of enterprises and banks owing to inadequate accounting systems, limited experience in risk analysis of potential borrowers by banks, inadequate tax regimes for making loan-loss provisions, lack of experienced supervisors and auditors and inadequate prudential regulations. While ineffective banking supervision may be an additional cause of financial fragility, the weak balance sheets of the banks in turn narrow the scope for proper enforcement of prudential regulations. Thus, the re-capitalization of the banking sector and the restructuring of inherited substandard loans are key elements of the reform of the financial sector.

The heightened sensitivity of exchange rates and other financial asset prices would be of less concern if banks and other financial institutions were strong and well capitalized. The *weakness in banking* supervision in emerging market economies has been a major problem for the rest of the world.

ii) *A strong capital market infrastructure*

In addition to a robust banking sector, participation by emerging market economies in the international financial system requires macroeconomic stability and a proper capital market infrastructure, which entails:

- an adequate legal framework
- efficient and reliable clearing and settlement systems
- an adequate accounting system
- an efficient microstructure for trading securities
- a proper regulatory and supervisory framework
- the proper market-based framework (legislation, supervision, disclosure requirements, a professional asset management industry, etc.) for institutional investors.

In many countries in Latin America and Asia, fixed-income securities markets are absent or underdeveloped. This, in turn, has led to an excessive reliance on foreign and domestic bank financing, making the participation of these countries in the global financial system more vulnerable to shifts in expectations and perceptions. In sum, both a sound banking system and a liquid domestic capital market are key elements of a robust financial infrastructure.

iii) *Adequate risk management systems in the new financial landscape*

Efficient market-based financial systems require an effective framework for managing risks. Risks in financial markets have changed in the past two and a half decades reflecting the changing nature of financial intermediation. Banks (and other depository institutions) began to engage in activities for which they were sometimes ill-prepared, a problem aggravated by the relatively low level of bank capitalization in some countries. Simultaneously, other fundamental structural changes occurred in financial markets, including: the abolition of exchange controls in many OECD countries and deregulation of domestic financial markets; more active asset and liability management, changes in the type of financial assets held by households; a more prominent role of institutional investors, the use of derivative technology; and greater importance of the treasury function for companies.

Moreover, new risks, associated with desegmentation, securitization, financial innovations, globalization, and increased competition, have

emerged. Increased volatility, greater interdependence, and new risks have also made the structure of the risk exposure of banks and other financial institutions more complex. For banks the traditional activity was 'on balance sheet' lending, and the associated risk management technique was credit risk analysis. However, lending now accounts for a smaller share of total activity than in the past for many banks. Newer activities are investment banking, origination, trading (agency and proprietary), mergers and acquisitions and information systems –where the risks are different. The fact that banks will increasingly hold a wider set of instruments and that some of the risks in these assets will be retained while others are passed on implies that risks must continually be identified and quantified and systems must be set in place to offset risk or to hold sufficient capital against any risk that is retained. However, although new risks have emerged, the so-called 'old' forms of risks –including 'Herstatt risk' (defined as the risk connected with cross-currency settlement) and traditional credit risk– have not disappeared. Despite the growing complexity of risk, the greatest problems in bank solvency in the past two decades have come from credit risk.

Proprietary trading is an increasingly important activity of financial institutions, meaning that in addition to the risks regularly assumed in the business of intermediation or 'underwriting', banks will have to take operational views about the direction of markets. Meanwhile, the product cycle in financial services is operating at a faster pace. New financial services require constant innovation with constant pressure on margins.

With these new developments, financial institutions must improve their capabilities for defining, managing and pricing risk. The general objective is to build and use systems for the disciplined management of credit risk, market risk and liquidity risk. The primary components of a sound risk management process are: a comprehensive system for measuring the different types of risk; a framework for governing risk-taking, including limits, guidelines and other relevant parameters; and an adequate management information system for monitoring, reporting and controlling risks.

Policy-makers can contribute to these objectives by establishing efficient regulatory and supervisory systems for managing risks. Also, efforts by the authorities to improve clearing and settlement systems for payments and securities –including those related to cross-border transactions– are key in encouraging the adoption of risk-reducing procedures and quantitative risk management models by market participants.

Nonetheless, a word of caution is warranted in the use of quantitative risk management models, including VAR. Perhaps VAR models are creating the false illusion that risks are sufficiently under control (while they are not). In fact, some authors argue that current risk management practices such as VAR

capture only one dimension of risk: the *probability* of monetary losses (Lo, 1999).⁷

The implementation of risk management systems requires the adoption of a proper risk accounting framework.⁸ This will require more sophisticated investment guidelines based on sound risk management standards that take into account the unique characteristics of pension funds and other institutional investors. In this context, it has been suggested that financial accounting needs fundamental revisions to develop a specialized new branch called 'risk accounting'. The traditional accounting system is therefore not very suitable to identify risk allocations. Although contracts like interest-rate swaps and future contracts have no initial value, they can have an immediate and significant impact on the risk exposure of the various assets and liabilities on the balance sheet of pension funds and other institutional investors. Changes in accounting structure and methodology are required to address this inadequacy by developing risk accounting standards.⁹

Another challenge concerning the use of risk models is the possibility of herd behaviour owing to the use of risk management models that operate on the basis of international variance-covariance matrices of market prices or macroeconomic variables. They imply that a jump in volatility in one country will automatically generate an upward re-estimate of market and credit risk in a correlated country, mechanically triggering margin calls and tightening credit lines. Thus, the widespread and mechanical use of risk management may become a source of contagion (Folkerts-Landau and Garber, 1998). In addition, there is some evidence that VAR models could encourage, perversely, excessive risk-taking by traders.¹⁰

iv) *The role of the exchange rate regime*

Another challenge confronting the international financial system is establishing and retaining more robust currency regimes. The new technical features of this new financial system (see above) increasingly determine the optimal exchange rate, instead of the more traditional factors such as country size, openness, labour mobility, integration with trade partners, fiscal

7 Lo (1999) argues that 'Total Risk Management' (TRM) must include two additional dimensions: prices for assessing how much one must pay for hedging the various risks; and *preferences* concerning how much risk to bear (and thus how much to hedge).

8 I am indebted to Zvi Bodie for bringing his work on this policy issue to my attention.

9 The prospect for such development is not just hypothetical. Pressed by the reality of the market place, financial firms that deal extensively in complex securities have already developed risk accounting protocols as part of their internal risk management systems. With the benefits of real-world experience, these protocols could serve as prototypes for standardized risk accounting.

10 Benedict Roth (1999) argues – based on research by Ton Vorst at Erasmus University – that the use of VAR models tends to increase exposure by traders to extreme (and catastrophic) events.

cushion, reserves, etc. In this context it has been argued that only 'polar' solutions are optimal: fully flexible rates on the one hand, and irrevocably fixed (currency board or dollarization/euroization) on the other. The likelihood that a fixed rate peg, varieties of crawling peg and other intermediate regimes (e.g. target zones, managed float, crawling zones) will fail has increased in the new global financial landscape.

The latest set of crises was characterized by spectacular collapses of fixed rate pegs among emerging market economies under stress.¹¹ Consequently, domestic currency interest rates, reflecting devaluation probability premiums, are almost always higher in emerging market economies with fixed exchange rates than in the economy of the major currency to which the emerging economy has chosen to peg. Those sudden adjustments in pegged exchange rates wrecked the balance sheets of both financial and non-financial entities. However, at the end of the day the issue is not the stability of currencies, but the underlying policies that engender stable currencies. Even dollarization, or its equivalent in other key currencies, is not a source of stability if underlying policies and institutions are unsound. Open economies, governed by a rule of law with sound monetary, trade and fiscal policies and supported by a sound financial infrastructure, rarely experience exchange rate problems that destabilize those economies to the degree we have seen in Asia in the 1990s and Latin America in the 1980s.

Thus, there is no shortcut to sound fundamentals.

v) *The key role of standards for sound finance*

Internationally acceptable standards for participation in the new highly sensitive international financial system are essential to its effective functioning.

Greater transparency in the way financial intermediation operates and the quality of its supervision is crucial for a sound international financial system. Markets cannot work efficiently, and they will remain vulnerable to major disruptions in the absence of adequate, timely and reliable information.¹² Codes of good practices and standards on transparency in monetary, fiscal and financial policies have been established or are in the process of being adopted. Moreover, much work has been or is being done on standards, principles, or good practices in the following areas: accounting, auditing, payment and settlement systems, insurance, bankruptcy and corporate governance.

11 Obstfeld (1998) and Obstfeld and Rogoff (1995) have documented the experience with fixed exchange rates. They conclude that numerous countries have tried to fix their exchange rates, but that few have been able or willing to do so for longer than five years, revealing a declining reliance on pegged exchange rates in favour of exchange rate flexibility.

12 Obstfeld (1998) argues that the greater transparency is a *public good* in situations where investors can allocate resources over risky foreign assets and where they face a fixed cost of obtaining information about each country. See Calvo and Mendoza (1997) for a formal model.

b) *Sound debt management: the need to avoid currency and maturity mismatches*

The effective management of the domestic and external debt of both the private and public sectors is of great importance for the successful participation of countries in the international financial system. Mismatches of maturity and/or currency have been identified as an important reason why countries experienced financial crises. Some countries in which the private sector or government issued large quantities of short-term maturity, foreign currency-denominated debt, became very vulnerable to sharp swings in the sentiment of foreign investors.¹³ Sound debt management is part of a proper risk management system. An effective framework for the management of risk would therefore ensure that governments and private sector participants would avoid a situation in which they would become very vulnerable to *debt runs*, either via a self-fulfilling debt crisis or a debt run owing to adverse fundamentals. Debt runs and speculative attacks on exchange rates can be linked via a dramatic loss in foreign exchange reserves or via the large unhedged foreign exchange liabilities of domestic banks (Rogoff, 1998). Rogoff concludes that countries with intermediate fixed rate regimes run a significantly greater risk of triggering off a debt run or a general financial market panic than countries with a fully floating exchange rate regime.

c) *The mistaken road of capital controls*

A good part of the capital that flowed into emerging financial markets in recent years (largely in the 1990s) probably reflected in large part the strong increase in equity prices in many OECD countries. The sharp rise induced a major portfolio adjustment in OECD countries by investing into the rapidly growing economies of Asia and elsewhere. This portfolio adjustment may have been further enhanced by the longer-term prospect of an 'ageing' OECD area and the associated lowering of future economic growth, on the one hand, and the perceived benefits of potentially higher rates of return in fast-growing, relatively capital-poor, demographically younger emerging market economies (Blommestein, 1998b). The tendency to downplay the risks of lending in emerging markets together with overly optimistic assessment about their prospects, reinforced by the propensity of governments explicitly or implicitly to guarantee such investments in a number of emerging markets, led to an excess of lending.

¹³ A government with high short-term debt has the same kind of maturity mismatch as in the classic Diamond-Dybvig bank run model because most of its assets (the present value of future tax payments) are fairly illiquid (see Rogoff, 1998).

Standards of due diligence on the part of both lenders and borrowers turned somewhat lax in the face of all the optimism about the prospects for growth in emerging markets. The consequent emergence of heavy losses and near-insolvency of a number of borrowing banks and non-financial businesses engendered a rush by foreign capital to the exits and induced steep declines in the economic growth in these countries. At that point the damage to confidence of the affected emerging market economies had already been done. Policies to block repatriation of foreign funds, while offering temporary cash flow relief, have significant long-term costs and clearly should be avoided if at all possible.

The notion that controls can be imposed temporarily, while an economy stabilizes, and then removed, gives insufficient recognition to the imbalances that emerge in an economy when controls are introduced. Removing controls subsequently creates serious problems.

It is often stipulated that while controls on direct foreign investment and its associated technology transfer are growth inhibiting, controls on short-term inflows do not adversely affect economic welfare. This line of reasoning is flawed as the free flow of short-term capital makes possible the servicing of direct investments as well as the financing of trade. In addition, it is often difficult to determine whether certain capital flows are direct investments or short-term in nature. Financial engineering increasingly plays a role in the blurring of short-term and long-term investment flows. Structured notes and other complex OTC instruments are also used for circumventing capital controls, making the use of official restrictions increasingly obsolete in the new financial landscape (Garber, 1998).

A more fundamental argument against the use of capital controls is based on the potential high welfare costs of capital market autarky. Rogoff (1998) notes that capital controls that reduce the international trade in short-term bonds and other portfolio instruments could have great costs. Moreover, efficient financial intermediation at the longer end of the market requires high liquidity at the short end of the market.

Finally, Chile is often cited as an example of the successful use of controls on short-term capital inflows.¹⁴ But in response to the most recent

¹⁴ However, Reisen (1999) notes that the impact of the Chilean measures was weak and that the controls were supported by both a culture of transparency and enforcement as well as sound macroeconomic policies.

international financial turmoil, Chile has chosen to lower its barriers in order to encourage more inflows.¹⁵

5. Conclusions

The new global financial landscape has led to a strong increase in the creation of value and standards of living. World financial markets are far more efficient than ever before. This is good news for both advanced and emerging economies because there is a growing body of evidence that financial sector development contributes significantly to economic growth. The structure and soundness of the banking sector, a liquid capital market and, more in general, a robust infrastructure underpinning the financial sector are therefore of vital importance. Hence, the attention of policy-makers must turn towards ensuring that the appropriate financial infrastructure is in place to support the development of an efficient financial system. The fact that the new global financial landscape is capable of transmitting disturbances or mistakes at a far faster pace throughout the world economy than before, has made this even a higher policy priority than before.

Recent financial crises, while sharing many, if not most, of the characteristics of past episodes, appear different. The crises seem to reflect an increase not only of risk but also of *uncertainty*. The vastly accelerated pace of financial activity –its complexity and its volume– has created a very challenging environment for both market participants and policy-makers, especially during slumps in asset prices. This raises fundamental questions about how best to respond to the challenges of the new brave world of finance. The new global financial landscape has at times experienced severe bouts of stress. In this context, market participants' use of leverage have come under scrutiny. Volatility and contagion are clearly enhanced by leverage. This raises the key public policy question to what extent the degree of leverage that was viable in an earlier period is still appropriate in today's more volatile financial environment. Supervisors need to determine the proper balance between the benefits leverage confers to markets and the potential systemic risk posed by high levels of leverage (President's Working Group on Financial Markets, 1999). If financial asset prices are more volatile and financial contagion more frequent, market participants need to protect themselves against unexpected adverse market conditions by having more robust financial structures. Sound risk management systems are a key part of this. However, to the extent that policy-makers and market participants are unable

15 It has been argued that the Chilean regulation of capital inflows via reserve requirements is being used as a counter-cyclical tool which, depending on its height, may or may not have a strong impact on capital inflows (see Agosin and Ffrench-Davis, 2000). Clearly, this feature is different from policy effectiveness in terms of its potential impact on social welfare (e.g. as mentioned in Rogoff, 1998).

to anticipate or evaluate the types of complex risks the newer financial technologies are producing, it creates a fundamental uncertainty in the financial system. A rational response to this increase in *uncertainty* is the following rule-of-thumb: the higher uncertainty, the lower leverage -i.e. less debt, more equity, and, hence, a larger buffer against adverse circumstances and stresses in the financial system.¹⁶

Another key challenge for the authorities is to maintain macroeconomic stability during periods of structural changes and opening of the domestic financial system. A rapid liberalization of the financial sector without having in place effective instruments of macroeconomic control and other conditions for sound finance (such as effective banking supervision and adequate regulations), may result in a financial crisis and recession. An efficient system of financial intermediation and its international integration may provide substantial benefits.¹⁷ Nonetheless, a too hastily and inconsistently executed financial liberalization programme is likely to result in a financial sector crisis, macroeconomic instability and a growth collapse, as shown by the recent crises in some emerging financial markets.

16 The Counterparty Risk Management Policy Group –a group of 12 major commercial and investment banks– has argued that the definition and interpretation of *leverage* pose difficulties for risk management. The Policy Group believes therefore that leverage is not an independent risk factor whose measure can provide useful insights to risk managers and supervisors. Instead, leverage should be assessed by its impact on market risk, funding liquidity risk and asset liquidity risk (see Counterparty Risk Management Policy Group, 1999). However it should be noted that in making this recommendation the Policy Group makes the tacit assumption that all risks can be properly measured. This is by definition *not* the case in a situation with an increase in uncertainty.

17 Rogoff (1998) points out that the welfare benefits of international financial market integration are likely to be much higher than suggested in the academic literature.

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8. TOWARDS A NEW FINANCIAL ARCHITECTURE: THE MANAGEMENT OF CRISES

*Stephany Griffith-Jones **

1. Introduction

The deep integration of developing countries into the global economy has many advantages and positive effects. In particular, capital flows to developing countries have clear and important benefits. The benefits are especially clear for foreign direct investment (FDI), which is not only more stable but also brings technological know-how and access to markets. Other external flows also have important positive microeconomic effects, such as lowering the cost of capital for creditworthy firms. At a macroeconomic level, foreign capital flows can complement domestic savings, leading to higher investment and growth; this latter positive macroeconomic effect is very valuable for low-savings economies, but may be less clear for high-savings economies like those of East Asia.

However, large surges of short-term and potentially reversible capital flows to developing countries can also have very negative effects. First, these surges pose complex policy dilemmas for macroeconomic management, as

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they can initially push key macro variables, such as exchange rates and assets prices like property and shares, away from what could be considered their long-term equilibrium. Secondly, and more important, these flows pose the risk of very sharp reversals. These reversals -particularly if they lead to currency and financial crises- can result in serious losses of output, investment and employment, as well as sharp increases in poverty. This has been dramatically illustrated by the impact of the current crisis in Asia, which has now spread to many other countries, including most recently Brazil.

Asian-style currency crises -and their extremely high development costs- raise a very serious concern about the net development benefits for developing countries of large flows of potentially reversible short-term international capital. While the high costs of reversals of those flows are evident, the benefits are less clear. This is in sharp contrast with FDI and trade flows, where the very large developmental benefits clearly outweigh the costs. As a result, volatile short-term capital flows emerge as a potential Achilles' heel for the globalized economy and for the market economy in developing countries. If the international community and national authorities do not learn to manage these flows better, there is a serious risk that such volatile flows could undermine the tremendous benefits that globalization and free markets can otherwise bring.

The current functioning of the international financial system is clearly unsatisfactory, particularly because it leads to recurrent financial crisis, with high development costs especially implying increases in poverty for developing countries. It thus risks undermining the development achievements of the otherwise broadly successful market reforms. 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. This chapter aims to contribute to the discussion, by making more precise and comprehensive proposals, focusing on issues of better crisis management. Though we see crisis prevention as preferable and less costly (developmentally and financially) than crisis management we realize that crises may still happen. Therefore in this chapter we focus on crisis management (for a detailed discussion on crisis prevention, see for example Griffith-Jones and Ocampo with Cailloux, 1999).

Section 2 deals with the appropriate scale, timeliness, modalities and conditionality in the provision of official liquidity in times of crisis, including a discussion of the recently created Contingency Credit Line. Section 3 deals with involving the private sector in crisis management -for example, via amendment of bond clauses or via standstill arrangements. Section 4 concludes.

2. Provision of official liquidity in times of crisis

a) The role of IMF and other institutions in official liquidity provision

The need for liquidity provision in times of crisis 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', which is not exactly matched by the IMF. Particularly, the Fund provides exceptional lending but certainly not liquidity,¹ a fact which is reflected in the lack of automaticity in the availability of financing during crises. Such an emergency financing role has led 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 the IMF's agreements to borrow. Some major advances during the recent international financial crises were 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 analyzed in more detail in the following sub-section.

b) 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 destabilize economies in a matter of days, a lesson that the international community learned during the Mexican, Asian and post-Asian shocks. It is also, above all, 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 who are victims 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 balance of payments problems that might arise from international financial

1 This important distinction is made by Helleiner (1999).

contagion' (IMF, 1999). To qualify, the increased pressure on the recipient country's capital account and international reserves must thus result from a sudden loss of confidence among 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 an important 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.² 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. Put differently, the CCL provides a strong incentive for countries to make sound policy choices that provide a stable economic and financial environment. 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 given to an economic and financial programme to be implemented.

ii) *Macroeconomic performance*

The Article IV consultation is used as a benchmark for economic performance. An ongoing assessment of the country is also carried out once

² The SRF was created at the end of 1997 as a response to the Asian financial crisis. It provides financial assistance for exceptional balance of payments difficulties owing to a large short-term financing need resulting from a sudden and disruptive loss of market confidence. Up to now, SRF loans have been made to Korea (US\$2.8 billion), Russia (US\$0.9 billion) and Brazil. The lending terms for the SRF are similar to those for the contingency facility.

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 yet been finalized (notably the codes of transparency in monetary and financial policy). Other standards include the subscription to SDDS, the Basle Core principles for bank supervision and the code of transparency of fiscal policy. 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 also are conditions. These conditions should help prevent Asian-style crises in the future and are therefore very positive.

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, a least in five areas:

First, the question of the *scale of liquidity provision*. Ideally, the size of the CCL is unlimited. This is imperative as very large amounts of liquidity might be required in times of 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, because of financial constraints, the Fund has disclosed a range of disbursement from 300 to 500% of the member nation's IMF quota.³ This limitation is problematic, as in a crisis it is the unlimited nature of contingency financing which 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.

³ In April 1999, the Fund had US\$76 billion in uncommitted resources plus US\$46 billion available under pre-arranged credit lines.

Estimates from April 1999, based on the upper ceiling of 500% of quota, evaluate the CCL to be of an order of US\$ 20 billion for Brazil, US\$ 11 billion for Korea and US\$ 7.4 billion for Thailand. Countries like Argentina would receive up to US\$ 14 billion, Chile US\$ 6 billion, Mexico US \$17 billion, Hungary US\$ 7 billion and South Africa US\$ 12 billion (Chote, 1999; Davitte, 1999). These amounts appear quite low and could turn out to be insufficient to fully absorb external shocks. For example, Brazil, which accessed a financial package in some 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 they were applying to the scheme although some policy-makers had expressed their opinions on it. Mexican officials, for example, fear that they may not be eligible owing to their current involvement with the IMF through a stand-by loan facility. Others have underlined the paradoxical situation of 'good' countries not being willing to be labelled with the CCL while countries in potential difficulty finding it very hard to comply with too stringent conditions.

Second, the special 'activation' review by IMF Board -as the CCL is today structured- does not look 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 together with 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 contagion.

Furthermore, the automatic triggering is critical to the good functioning of the CCL as it would give *instantaneous access to new liquidity*. Indeed, as seen recently in several cases, a loss of confidence can have major impacts in a very short period of time. A few hours or days might then have a determinant impact on the outcome of the crisis. The approval required by the Board, even if it were expeditious, would still not be fast enough and could allow large outflows of funds.

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 losing their access to it. A certain degree of confidentiality could possibly dampen this effect. For example, information

could be disclosed only on countries that have been accepted but not on those applying.

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.

Fifth, although the conditions defined by the IMF for pre-qualification should on the whole help avoid crises, there is a danger that some policy actions, specifically targeted at strengthening investors' confidence might discourage growth. And finally, there could be the risk that countries receiving a CCL would have *too large inflows*, owing to excessive confidence from private investors.

So, despite significant advances, in practice the approved credit lines will continue to lack the full stabilizing effects that are expected from IMF interventions during a crisis, as 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 available 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, as stabilizing effects will continue to be absent to the extent that the market judges that the intervening authorities are unable or unwilling to supply funds in the quantities required to stabilize speculative pressures. Moreover, under these conditions, national authorities may be forced to overreact, adopting a procyclical 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 possibly be to allow additional issues of SDRs under critical financial conditions, to create the additional liquidity required (see United Nations Task Force, 1999). These funds could be destroyed once financial conditions normalized. This procedure would also create an anti-cyclical element in world liquidity management and would give SDRs an increasing role in world finance, a principle that developing countries advocated in the past and should continue to do so. Though technically very attractive, 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 long time. A second-best alternative would be to allow the IMF to raise in the market the resources needed to adequately fund contingency financing or to rely on Central Bank swap arrangements, arranged either by the IMF or the BIS.

3. The role of private sector involvement in 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.⁴ These would mainly 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 and the people of the capital-recipient countries see their country’s growth undermined and suffer large increases 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.

a) *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, particularly to debtor countries.

An important reason for contingent financing arrangements is the existence of multiple equilibria (Stiglitz and Bhattacharya, 1999). Individual lenders and investors, who believe that others are going to withdraw their money, do so for that reason. 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.

4 For a very useful overview of such measures, see IMF (1999).

We have discussed above contingent finance provided by the IMF and other official bodies -and, in particular, the recently created CCL. It seems important that such official facilities are complemented by private contingent credit lines. Indeed, one of the possible preconditions 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 website).

An important operational issue is how private-IMF credit levels would be coordinated 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 finalized afterwards. Though this could reduce the scale of IMF lending, and improve burden-sharing, between the official and private sector, it could lack determinancy. 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. The Indonesian and Mexican lines have been drawn; it is interesting that Mexico's creditor banks initially argued against the drawing, even though as IMF (1999) rightly argues, Mexico had adhered strictly to the arrangement. However, the loan was disbursed when Mexico requested it. Mexico's Finance Minister Gurría argued that the creditor banks resented disbursing loans at the low spreads that had been precommitted, at a time when spreads for Mexico and other emerging market countries were much higher.⁵ 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 crisis- increase the cost of such borrowing. The Argentina line has not been drawn, but its existence may have helped forestall market pressures.

This clearly seems an appealing mechanism. However, several questions remain. First, would banks be willing to provide this kind of financing to a broad range of countries -including, for example, poorer ones? Secondly, do these facilities really provide additional financing in times of crisis, or do they partly crowd out other lending? This would clearly reduce the positive impact of such an arrangement.

5 Presentation in May 1999 at HSBC, London; personal communication.

b) Restricting derivatives 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 or 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 underestimate 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- as these countries have increasingly accepted puts recent years, as derivatives became more widespread and as the risk of crises increased (for example, in Brazil, the share of 'puttable' bonds increased significantly as the crisis approached). According to the IMF (1999), a minimum estimate of US\$20 billion in loans and bonds was 'puttable' 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 or using derivatives, such as put options, as well as other such investments when these increase countries' vulnerability to crises. It is also important to improve transparency and understanding of such modalities and 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, World Bank, BIS or others) could thus be very valuable, and particularly so for poorer countries.

c) Amending sovereign bond clauses

There is an urgent need to have flexibility in debt contracts for the case of unpredictable shocks arising. In a national context, this can be achieved by bankruptcy proceedings. While 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 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 placements increasing from US\$6 billion in 1992 to over US\$40 billion in 1997 and 1998; this also leads to rapidly growing amortization of bond finance. Particularly true for Latin America, 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 bond holders 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 and thus reduce the potential resources available 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) and has been both supported and developed further in the 1999 IMF document on *Involving the Private Sector*. 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, IMF, 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 needs to 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 clarifying of the 'rules of game' could 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 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 (which would be extremely unlikely to increase their spreads), this would imply that it would become far more acceptable for developing countries to do so, and that negative effects on availability and cost of new bonds would deteriorate far less than if they did it on their own. However, there seems to be some resistance among G-10 governments to undertake such changes.⁶ The reasons given are purely technical, but the

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problems raised seem relatively small, so they could be easily overcome if the political will was there. One problem raised is that not all G-10 countries are currently active in international markets; this could be overcome by modifying bond clauses only for those G-10 countries currently issuing bonds or by G-10 countries making a small symbolic issue of bonds, beyond their normal funding programme, or announcing that if in the future the G-10 country issued bonds, they would have those modified clauses. 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, bond holders or the trustee (if there is one, see analysis below) to call bond holders' meetings, and for a *qualified majority* of bond holders 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 bond holders are generally prohibited from accelerating the bonds and initiating litigation. As IMF (1999) 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 bond holders. In the case of Trustee Deed bonds, the limits on individual creditors to initiate litigation provides 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 bond holders 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.⁷ This is rather encouraging, as it would imply that drawing on the precedent of UK-style bond clauses and generalizing 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

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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 focused 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 bond holders 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 bond holders. Such trustees can: (a) prevent bond holders taking unilateral action and (b) provide a useful channel for communication and possible negotiation between bond holders and the debtor.⁸

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 among 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.

There has also been growing international consensus on the need to create internationally sanctioned standstill provisions, though these proposals have been less well worked out by institutions like the IMF, especially on the legal aspects. However, it is important that the G-22 report has 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 coordination 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

⁸ I thank Robert Gray for this point.

higher output, fewer bankruptcies and –probably– fewer long-term disruptions to capital flows.

The G-22 report went further in recognizing that there may be extreme cases when an orderly and cooperative restructuring process would be aided by ‘an enhanced framework for future crisis management’, that 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 on payments to private creditors. According to the G-22, this signal (and the explicit support which the IMF would give thus to the standstill) would be provided only where the international community believed 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 cooperative and non-confrontational process would hopefully be less penalized by creditors.

UNCTAD (1998), which has provided one of the most forceful and detailed defences 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 renegotiation agreements (e.g. 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 recognize default risks that already exist, and that it could actually reduce the default risk for individual operations. Alternatively, it could be argued that if 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 (e.g. 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. First, 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, 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 Korea and Brazil, even though the delays in arranging them led to fairly significant haemorrhaging of outflows before it was arranged. However, in Korea, the concerted roll-over of short-term bank lines was helpful in stabilizing 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, particularly 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, 1999) that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted roll-over.

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

4. Summary and conclusions

It seems important to attempt to evaluate progress so far, as regards the reform of the international financial architecture. A positive feature is that a fairly important proportion of the proposals on the table by spring 1998 (for a review and analysis then, see for example, Griffith-Jones, 1998) have either been seriously studied or actually begun to be implemented. This is particularly true for those proposals that do not require significant institutional innovation.

Among the most positive steps, as regards crisis management is the creation of new facilities of the IMF (including most recently and significantly the CCL). However, the way in which it has been implemented has limitations. Furthermore, in the areas of amending bond clauses and internationally sanctioned standstill arrangements, little actual action has taken place, though the discussion has become increasingly more specific and certain consensus seems to be broadly emerging.

As regards the creation of the CCL, it is potentially an important step forward to limit contagion, by encouraging countries to adopt policies that will discourage crises happening and by signalling to the markets that this facility is available. Both may help avoid crises happening. However, there are several concerns about the way the CCL is being structured. First, would the scale be sufficient to stem a 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 best official liquidity can be used in emergency financing.

As regards 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 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 concrete progress be made on orderly debt workouts, 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 stigmatizing and marginalizing developing country borrowers. In particular, should modifying bond contracts be imposed by IMF conditionality on developing

country debtors, as has been suggested? While bond covenants are not modified for all countries -including developed ones- developing countries may 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 increases 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 proposals 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, by both 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 this chapter has focused more on issues of international measures to better manage crises, clearly these need to be complemented by international crisis prevention measures and by national measures, both in the prudential and capital account regulatory area and in macroeconomic policy. Prudence in the liberalization of certain categories of capital flows (the more volatile ones) is also an important area.

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9. BEYOND BRETTON WOODS: WHAT INTERNATIONAL MONETARY AND FINANCIAL SYSTEM FOR THE TWENTY-FIRST CENTURY?

*Alexander K. Swoboda **

1. Introduction

'The governance of financial globalization: from Bretton Woods I to Bretton Woods II' was the theme for the session of this conference at which this chapter was originally presented; it is also the agenda for international monetary and financial reform -or, to use the expression currently in vogue, for strengthening the international financial architecture. I shall endeavour to take stock of where we are today and where we are likely to go in the next few years with respect to the evolution and prospects for reform of the international monetary and financial system (IMFS). This chapter does so in broad outline and with bold brush strokes. In the course of the argument, I will try to develop briefly the following points:

- (1) The evolution of the international monetary system in the post-war period has been a gradual one, in which we can recognize four main phases. It has not been the outcome of a grand design, nor is such a grand design likely for the near future. We will not have a Bretton Woods II -partly because we are already in Bretton Woods IV.

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- (2) The world in which we live, and the organization of the system, differs fundamentally from that which the founders of the Bretton Woods system faced and envisaged. Today's financial, capital and goods markets are integrated to an extent that in some ways is unprecedented in history and into which developing countries are increasingly drawn. Markets are integrated but policy-making is largely a national matter.
- (3) Looking forward, there are a number of features of the system which any sensible attempt to improve its functioning must take as given, notably volatile exchange rates among the major currencies and a high degree of capital mobility.
- (4) There are a number of grand plans that simply have no chance of being implemented.
- (5) The measures that are being put in place -such as better supervision, agreed international standards, transparency, codes of conduct and better workout procedures are steps in the right direction but will not suffice to eliminate crises.
- (6) Although the creation of an international lender of last resort is not feasible in today's circumstances, a case can be made for the provision of emergency lending by the international official community, more specifically by the IMF. More generally, a world in which large nations gear their macroeconomic policies to internal goals (and can afford to do so) and markets are integrated generates externalities for third countries, especially developing economies. It is crucial that international economic organizations -financial institutions, in particular- play a leading role in internalizing the positive externalities and in mitigating the negative ones.

2. From Bretton Woods I to Bretton Woods IV

Ultimately, the goal of any well functioning IMFS is to serve the real economy. It should permit an efficient allocation of resources, foster stability and not interfere with the distribution of income that socially mandated equity considerations warrant. Efficiency requires that trade in goods and services take place according to the principles of comparative advantage and that trade in assets over time allows capital to flow from where it is abundant and cheap to where it is scarce and dear. There are several dimensions to stability. First, the system itself should not generate instabilities -in particular, excessive variability in currency and other financial asset prices. Second, it should not systematically generate inflationary or deflationary biases- that is, it should ensure price stability or, if you prefer, provide an appropriate nominal anchor. Third, it should be resilient to shocks: on the one hand, it should not propagate financial shocks and be prone to monetary and financial crises; on the other, it should provide effective means for payments adjustment, in particular current account adjustment.

There are many ways in which these functions have been discharged in the post-war era. In one sense, we are currently entering a period, which we might call Bretton Woods IV, insofar as we can broadly distinguish four phases in the evolution of the IMFS since the Second World War.

The first phase corresponds to the reconstruction of war-torn Europe. It was characterized by severe trade and capital account restrictions and was dominated by the Marshall Plan and the European Payments Union (EPU). It was a far cry from the system envisaged by the founders at Bretton Woods. The EPU and the OECE, however, provided the framework for the gradual return to current account convertibility of the currencies of the major industrial countries in 1958, ushering in the second phase, which may be called the heyday of the Bretton Woods system. That phase was marked by the fixed but adjustable exchange rate regime enshrined in the Fund's original Articles of Agreement, with changes in parities occurring, in principle but not always in practice, under the oversight of the IMF which played a leading role in the provision of (conditional) financing of payments imbalances. The anchor of the system was a gold-dollar exchange standard which, however, rapidly came to be dominated by the dollar and the monetary policy of the United States. At the same time, the process of liberalization of current account transactions was broadened to an increasing number of countries and more gradually to capital account transactions. With the advent of the euro-currency and euro-bond markets, an international financial market developed during that period with the creation of the euro-markets, but its participants were by and large confined to the developed countries. That phase came to an end in 1971-73, first with the suspension of convertibility of the dollar into gold and the temporary floating of major currencies in August 1971, then with the collapse of the *de jure* dollar standard (created by the Smithsonian agreement of December 1971) in the spring of 1973 when floating became generalized among major industrialized countries.

The subsequent third phase of floating exchange rates, although the dollar and the macroeconomic policy of the United States remained at the centre of the system, saw the gradual emergence of a European currency area coupled with increasing capital market integration in the 1980s, and, more recently, the progressive drawing into an increasingly globalized economy of the so-called 'emerging market economies' and, with the collapse of the Soviet Union, of the transition economies. The liberalization of current account transactions proceeded rapidly in the industrialized countries and increasingly spread to the developing world. Capital mobility and globalization proceeded rapidly as well, with the dramatic decrease in transaction costs associated with the revolution in telecommunications and information technology and the attendant onset of a wave of financial innovations. Private capital flows came to play the major role in the financing of current account imbalances in the industrialized world and increasingly in developing countries as well.

The exchange rate regime, in that third phase, was (and still is today) a mixed one, with the currencies of the main industrial countries floating against each other with the exception of the repeated attempts at joint floating by various European Economic Community (EEC) countries, the launching of the European Monetary System (EMS), and the Maastricht Treaty which culminated in the creation of the Euro. For smaller and emerging market economies, a mixture of exchange rate regimes prevailed, with a growing trend towards the adoption of more flexible exchange rate arrangements rather than rigid pegs. This was also the period where the behaviour of the exchange rates of major countries became a source of concern. The short-run volatility of both nominal and real exchange rates was high, a number of medium-term swings in both exchange rates, sometimes identified as severe misalignments of currencies, took place -most notably, the strong appreciation of the US dollar in the early 1980s followed by an equally large, and abrupt, reversal starting in 1985.

The birth of the euro at the beginning of 1998 marks a fourth phase in the evolution of the post-war exchange rate system, towards a bi-polar system characterized by a high degree of capital mobility and a variety of exchange rate practices across countries.

3. A very different world from that of Bretton Woods

It is important to recognize the ways in which today's system differs fundamentally, in both conception and functioning, from that envisaged by the founders of the Bretton Woods system.

Briefly put, the Bretton Woods system was designed to cope with the problems of the inter-war period, competitive devaluations, trade restrictions and discrimination and excessive volatility in exchange rates in a nationalistic environment. The design therefore was one of fixed but adjustable exchange rates, so to avoid competitive depreciations while permitting enough flexibility to adjust to fundamental disequilibrium under international supervision. Current account convertibility was an explicit goal of the Fund's Articles of Agreement, but capital account controls were allowed. In fact, they were expected to be widely used to insulate the real economy from instability in short-term capital flows. The IMF was to be the main source of temporary official financing of payments imbalances and thus to smooth out the adjustment process. The present system is of course very different, both in its functioning and in the role of various actors. The exchange rates of major countries fluctuate widely and exhibit significant medium-term movements. Capital controls have by and large been abandoned by industrial countries and, more recently, increasingly by emerging market economies. Capital mobility is very high and private capital flows have come to play a major role

both in financing payments imbalances and in generating payments disturbances. And the adjustment process has, on occasion, been anything but smooth, as recent events testify.

These changes in the functioning of the system mirror changes in economic reality, in particular:

- Capital markets are increasingly globalized and emerging market economies are rapidly becoming integrated in the world's goods and asset markets.
- The currencies of major industrial countries are floating; those of other countries follow a variety of exchange rate regimes.
- A bi-polar international monetary system, based on the dollar and the euro, is emerging.
- Capital controls have been either relaxed or largely removed in many countries.
- Flows of private capital have come to play a dominant role in balance of payments financing and adjustment.

A fundamental issue for the international community is how to cope with the problems these changes pose for the stability of the system while retaining their manifold benefits.

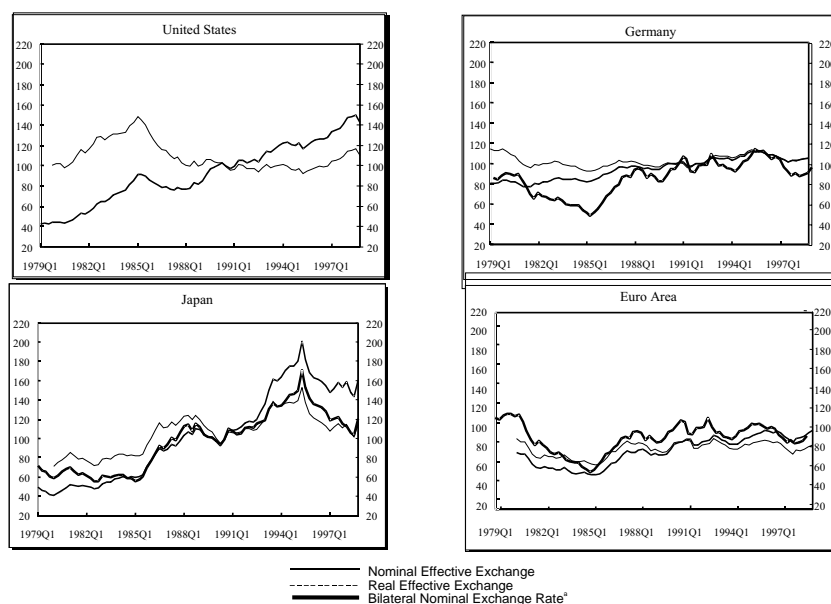
4. Continuing volatility of exchange rates and capital flows

Among major threats to international financial stability, instability in the exchange rates of major currencies and in capital flows figure prominently. One question that arises is whether such instability is likely to continue in the future.

Figure 9.1 shows the behaviour of the exchange rates of the US dollar, the yen, the German mark as well as that of a synthetic euro for the period 1979–98.¹ They exhibit well known characteristics: high short-run volatility, major medium-term swings (sometimes identified with misalignments), mild (except for Japan) trend appreciations or depreciations, greater stability in effective (multilateral) than in bilateral exchange rates. The point here is not to document these characteristics in detail but to ask whether they are likely to hold in the future also. More specifically, are the three major currencies of the beginning of the twenty-first century likely to exhibit significantly lower volatility in the future than in the past? The answer, I would think, is on the whole in the negative. There are several reasons for this assertion.

1 The weights used for the synthetic euro series reflect trade with countries outside the euro area only.

Figure 9.1
**SELECTED INDUSTRIAL ECONOMIES: BILATERAL AND EFFECTIVE
 EXCHANGE RATES, 1979/1 - 98/4**
(indices, average of 1990 = 100)



Source: International Monetary Fund, International Financial Statistics, Effective Exchange Rates Facility; the WEFA Group.

^a All bilateral exchange rates are U.S. dollar per national currency.

First, analyzing the monthly volatility of changes in the value of the currencies in Figure 9.1 of the synthetic euro in particular, shows no particular trend for the period 1973–98.² Second, the currencies of large, more closed, economies tend to exhibit larger fluctuations than those of small open economies. The euro area is a large economy with a share of trade in GDP that is similar to that of the United States. Third, major countries have, in the past, aimed their macroeconomic policies, their monetary policy in particular, towards internal goals, exercising benign neglect with respect to the exchange rate. This is also likely to continue in the future for the euro area where the

² This is documented in more detail for these and other currencies in a forthcoming IMF paper 'Exchange Rate Regimes in an Increasingly Integrated World Economy'.

price stability mandate of the European Central Bank (ECB) is particularly clear and where the ECB is keen to affirm its independence and establish the credibility of the euro. Fourth, as I argue briefly in the next section, a major initiative to stabilize the exchange rates of the three key currencies is most unlikely over the next few years.

As for capital mobility, short of a major disintegration in the world economy, it is likely to continue increasing in the future. It is, fundamentally, driven by technology rather than by a deliberate, autonomous, will to liberalize capital account transactions (to some extent the liberalization can be seen as a response to growing national costs of national controls in a world of increasing capital mobility). In turn, the potential for boom–bust episodes of major capital inflows to emerging market economies followed by sharp reversals is not likely to disappear. After all, the feast–famine syndrome in capital flows is not new. It has characterized the world economy for a long time. Considering only the post-war period, as Figure 9.2 -which shows total and private capital flows to developing countries from 1971 to 1998-illustrates, we have known two such cycles; the first building up to the debt crisis of the 1980s, the second to the Asian crisis of 1997.³

What is different about the current crisis is its scale, the spread of contagion, the diversity of sources and uses of flows, and the large output costs (as a percentage of world GNP) it has entailed.

5. Grand plans for reform of the IMFS

The severity of the Asian crisis and its novel nature have led to calls for reform of the international monetary and financial system and spawned the ‘new architecture’ industry. Radical proposals for reform range from the establishment of a world Central Bank, the creation of a world currency, that of a global financial supervisor and, at the other end of the scale, the abolition of international financial institutions (IFIs) and the instauration of universal floating of national currencies. Such grand schemes have, for better or for worse, no chance of being adopted in the time span that is relevant to current discussions.⁴

There are other only slightly less ambitious schemes that may appear more feasible but have serious enough drawbacks to make them either undesirable or unlikely to be adopted. Among those concerning the exchange rate regime, the target zone proposal has been revived in some European,

3 Figure 9.2 is reproduced from Mussa *et al.* (1999). See that paper for a detailed analysis of the boom–bust pattern in capital flows to developing countries and of the differences between the patterns associated with the 1982 debt crisis and those associated with the crises of the 1990s.

4 These schemes are described in some detail in Eichengreen (1999), who concludes that they have little chance of being adopted.

Figure 9.2a
DEVELOPING COUNTRIES: TOTAL AND PRIVATE CAPITAL FLOWS, 1971-98
(billions of U.S. dollars)

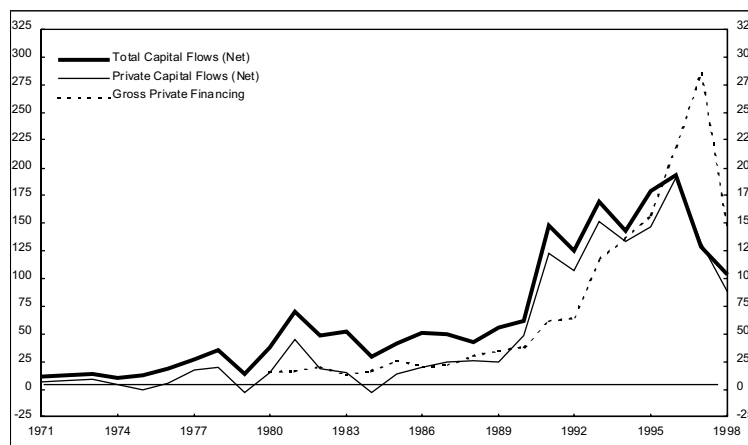
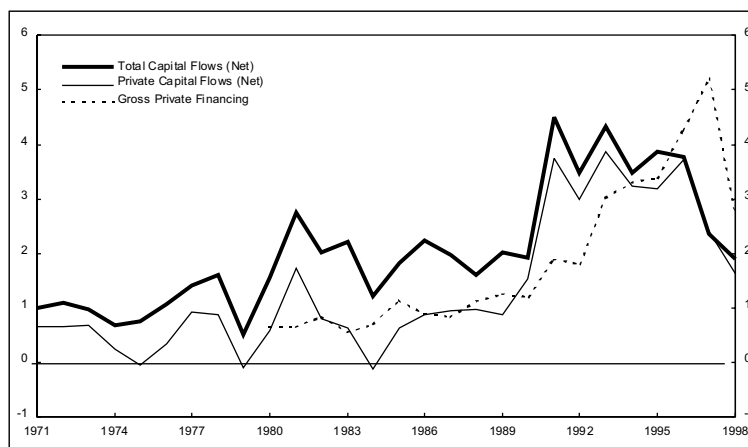


Figure 9.2b
DEVELOPING COUNTRIES: TOTAL AND PRIVATE CAPITAL FLOWS, 1971-98
(in percent of GDP)



Source: International Monetary Fund, World Economic Outlook Database and Developing Countries Bonds, Equities and Loans Databases.

mainly political circles, as a way to moderate the volatility and wide swings among exchange rates of major currencies, in particular the dollar–euro–yen triplet. There are a number of major problems, in particular lack of political commitment but also technical difficulties, which would most probably defeat the more ambitious of the target zone schemes.⁵ Those seek to calculate a fundamental equilibrium real exchange rate which would equate the current account to sustainable net capital flows, to translate that real exchange rate into a nominal one given current price levels and to put a fairly wide band around it to recognize the uncertainties involved in the calculation of the fundamental real exchange rate. Policy would then be used to maintain the nominal exchange rate within the band. Early versions of the target zone proposal were fraught with difficulties, in particular their partial equilibrium nature and their assumption that a number of real variables (e.g. real interest rates) could be attained through nominal (mainly monetary) policies. Later versions remove some of these flaws but there remain some serious problems, notably in the assignment of an insufficient number of instruments to a surfeit of targets. Other difficulties, in addition to the calculation of the fundamental equilibrium real exchange rate concern, on the one hand, the fact that the real exchange rate is an endogenous variable in the medium to long term and cannot (and should not) be controlled by monetary instruments in that longer term and, on the other hand, that such schemes are as, or more demanding, of international macroeconomic cooperation as more traditional attempts to manage nominal exchange rates.⁶ In addition, there are advantages to the major countries not sacrificing their domestic growth and stability of their price level, which are both essential for the world economy, to the requirements of exchange rate pegging.

As for the creation of new institutions with actual supranational powers, such as an effective global financial supervisory and regulatory agency, it is difficult to see how national governments and parliaments, especially among the richer industrial countries, would surrender sovereignty to them.⁷ And an international lender of last resort, in the usually accepted sense of the term, is utopian as long as there is no world currency or as long as the issuers of the world's two or three major currencies are unwilling to exercise that function for foreign as well as domestic financial entities.

5 See for instance Williamson (1985) and Williamson and Miller (1997).

6 See for instance Swoboda (1986) for a critique of target zone schemes and, more generally, for an early argument about the likelihood of exchange rate regimes gravitating towards the extremes of the spectrum between fixed and floating exchange rates.

7 Again see Eichengreen (1999) for that conclusion and a description of such schemes.

6. Will the implementation of current proposals suffice to stabilize the IMFS?

The measures that are currently being put in place under the label 'new financial architecture', such as better supervision, agreed international standards, transparency, codes of conduct and better workout procedures, together with measures to strengthen the financial sectors of developing countries, and emerging market economies in particular, are certainly steps in the right direction. But their implementation will take time and involves difficult trade-offs between efficiency and stability or between moral hazard and equity. It is one area in which the devil is in the details.

However, even if these measures are implemented, the system will remain subject to crises. The issue here is whether there are additional steps that could be taken, at the systemic level, to limit their frequency and amplitude and to mitigate their consequences. There are two sources of instability in the system where such additional steps seem highly desirable.

The first concerns the appropriate choice and improvement of the exchange rate regime to be adopted by major advanced economies on the one hand and by countries on the periphery, on the other. With respect to the exchange rate regime of the advanced countries, misalignments and instability in their exchange rates entail, as noted above, significant negative externalities for the countries at the periphery. For instance, the depreciation of the yen in terms of the dollar from 1995 to 1997 entailed a real effective appreciation of the currencies of those Asian countries -Thailand, in particular- which effectively pegged their exchange rate to the dollar. This real appreciation, though certainly not the main cause of the crisis, did contribute to those countries' vulnerability.⁸ This being said, benign neglect is an affordable luxury for the United States, Japan, or the euro area even if it is not for the countries at the periphery. Moreover, concentration on domestic goals may well be an appropriate policy for these large countries even from a cosmopolitan point of view, as healthy domestic growth and price stability in the G-3 is of overriding importance for the health of the world economy and because, in the absence of a world currency, it is essentially the dollar, the euro and the yen which provide nominal anchors for the world economy. Still, moderation in the fluctuations in the value of key currencies is a goal worth pursuing even for the G-3 countries as they have a stake in the stability of the periphery, all the more so that the stability of the international financial system as a whole is at issue.

⁸ Those countries, like South Korea, which had a more flexible exchange rate regime, did not suffer such loss of competitiveness, or at least not to the same extent.

What can be done to moderate misalignments is another matter. Having dismissed target zones, what is left? It seems to me that the multilateral surveillance process of the IMF, as well as Article IV consultations, have a potentially important role to play here. The methodology used by the Fund to identify potential misalignments and their sources appears promising and may serve as a first step in an informal coordination process. I will, however, not pursue this matter further here.⁹

The combination of continuing exchange rate volatility of major currencies and globalization of financial markets also has implications for the appropriate choice of exchange rate regime by developing countries. For those countries that have been increasingly drawn into the globalizing world economy both in current and capital account transactions, the choice is increasingly one between hard pegs and some form of floating exchange rate regime. The logic of a fixed exchange rate regime is that monetary policy must by and large be entirely subordinated to external equilibrium, to the defence of the peg. With a high degree of capital mobility, that logic is inescapable even in the short run; the regime will be stable and sustainable only if the commitment of monetary policy to maintenance of the parity is credible and believed by the markets. Currency boards and dollarization are essentially ways to seek to achieve that credibility. The logic of a floating exchange rate regime is to free monetary policy for domestic purposes; but for such a regime to be stable, monetary policy must provide the stabilizing anchor. Adopting an inflation target and granting the central bank independence are means to seek to achieve that aim. As argued above, however, the exchange rate is too important a variable for very open economies whose foreign (and often many domestic) transactions are conducted in the currencies of major advanced economies to be the subject of benign neglect. The regime for emerging market economies is therefore likely to be a managed rather than a pure float. It is, however, important that the exchange rate actually fluctuate; this is one way in which the actual risk of international lending and borrowing can be brought home to market participants and the implicit (or explicit) exchange guarantees extended by the authorities can be removed, together with the moral hazard and distortions in capital flows such commitments generate.

Indeed, the management of capital flows is the second area in which much remains to be done. If the boom–bust cycle cannot be eliminated it can at least be moderated. There are first the measures that the recipients of capital flows and victims of abrupt reversals may adopt themselves. These include the choice of an appropriate exchange rate regime as mentioned above, accompanied by the macroeconomic policies that obey the logic of that choice. They also include strengthening financial systems and eliminating the

⁹ On the Fund methodology for identifying potential misalignments see Isard and Faruquee (1998).

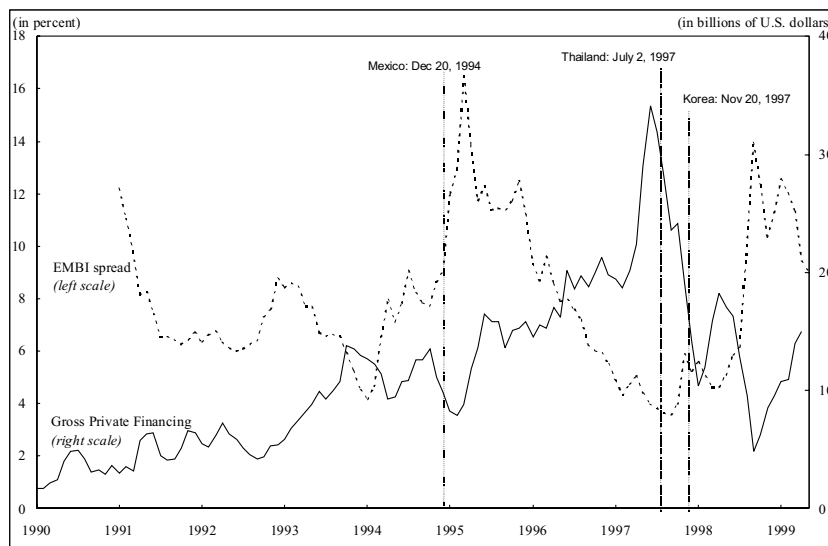
distortions that make for excessive capital inflows and, at the same time, render borrowing countries particularly vulnerable to abrupt reversals in these flows. Among the measures to that latter end, one may mention better debt management, better management of the national balance sheet with a view to limiting currency and maturity mismatches (including the elimination of distortions that serve as an incentive for such mismatches, such as the Korean restrictions on long-term capital inflows) and the elimination of implicit and explicit guarantees that generate moral hazard. Resort to market-friendly disincentives on short-term capital inflows of the Chilean variety may occasionally play a useful role in this context, in particular as part of a general strategy of orderly liberalization (Zahler, 1999), but they are neither a panacea nor generally applicable. Thus, at the international level, a return to generalized capital controls is neither feasible, short of police measures of unparalleled magnitude, nor desirable if the benefits of the participation of emerging market economies in world markets for both capital and goods and services is to be retained.

Turning to measures to be taken by lending countries, an argument can be made for putting as much emphasis on moderating herding in the boom phase of the cycle as on herding and contagion in the bust phase. After all, the latter would not be as violent, had the former not reflected a good deal of 'irrational exuberance'. Evidence for such behaviour on the part of lenders can be seen in the behaviour of spreads on emerging market debt. As Figure 9.3 –which relates gross private flows to emerging market bond spreads over the period 1990–99– illustrates, these spreads diminish as the boom phase gets underway and stay low until the crisis actually occurs both in the run-up to the debt crisis of the 1980s and in the run-up to the Asia crisis (and the Russian crisis).¹⁰

In other words, good behaviour on the part of borrowers, however necessary, is not enough; good behaviour on the part of lenders is also of the essence. Measures that contribute to the correct pricing of risk are thus to be welcomed, as are measures that remove the bias towards short-term lending in countries where capital flows originate –and the proposed revision of the Basle capital ratios in this direction is to be welcomed. This of course assumes that there is risk to be borne by market participants, both lenders and borrowers –that is, that moral hazard generated by implicit and explicit guarantees to lenders as well as borrowers is contained within reasonable bounds.

10 Figure 9.3 is reproduced from Mussa *et al.* (1999).

Figure 9.3
**DEVELOPING COUNTRIES: EMERGING MARKET BOND SPREAD^a
 AND GROSS PRIVATE CAPITAL FLOWS^b, 1990-99**



Source: International Monetary Fund, Developing Countries Bonds, Quites and Loans Databases and Bloomberg Financial Services. L.P.

^a JP Morgan Emerging Market Bond Index (EMBI, Brady narrow) sovereign spread over the theoretical U.S. zero-coupon curve.

^b Three month moving averages, annualized.

In the same vein, in an integrated world financial market, asset price inflation sometimes tends to occur simultaneously in several regions of the world, industrialized as well as developing, and it tends to be associated with simultaneous credit expansion. This suggests that monetary authorities in the industrialized world as well as in emerging market economies should pay at least some attention to asset price inflation and could thus contribute to moderate the boom part of the capital flow cycle.

7. Conclusions

Such measures as well as those which are being taken under the new financial architecture heading should prove helpful in making the IMFS more stable and less crisis-prone. But it will not render the system crisis-proof: crises will keep occurring and by their very nature will be unexpected. Nor are grand schemes likely to see the light of day or to be crisis-proof. After all, financial and economic crises do occur even within the confines of the most advanced economies. We have not reached the end of history yet.

In this context, two questions may be raised briefly by way of conclusion. The first concerns the likely shape of the IMFS over the medium run -say, over the next 10 years or so. The second concerns the role of the IMF in that system.

As to the first, today's system is made up of a complex set of rules and relationships between a wide variety of actors. Tomorrow's system, like today's is likely to grow organically and somewhat spontaneously rather than being the outcome of some grand design. Its governance is more akin to decentralized city planning than to deliberate architecture. As for exchange rate regimes, the system is likely to evolve into a bi-polar dollar-euro system with a number of countries in Western, Eastern and Central Europe pegging to the euro and eventually joining it and a few additional countries joining the dollar zone. An Asian currency area may also gradually emerge, but it is unlikely that the yen will be the single dominant currency in that zone unless and until a 'deep, broad and resilient' market for yen-denominated assets develops in the region -and until the yen ceases to appear doomed to appreciate. For the countries on the periphery, the system is likely to evolve towards the extremes, with a few countries adopting hard pegs of the currency board or dollarized variety and a number of others moving towards a floating rate regime. The latter, however is likely to be a managed float as countries whose trade and foreign assets and liabilities are predominantly denominated in foreign and not domestic currency, all the more so if they are very open, are directly subject to the fluctuations in the value of key currencies and cannot be reasonably expected not to have an active exchange rate policy -at least until they have built the institutions required to sustain a stable relatively pure floating exchange rate regime.

Second, a world in which markets are integrated, the macroeconomic policies of large nations generate externalities for third countries, especially the smaller developing economies. The volatility in key exchange rates and capital flows is one example. In such a world, it is important that international economic organizations, IFIs in particular, play a leading role in internalizing the positive externalities and in mitigating the negative ones. That is the purpose of the work on 'architecture' going on at the Fund and in other forums. This does not make the traditional functions of the IMF obsolete, on the contrary. Multilateral surveillance of the exchange rate policies of member countries, the major ones in particular, is becoming increasingly important, as I have argued. A good argument can also be made for extending that surveillance to the management of international capital flows.

Some observers have argued that the system should evolve towards one in which greater responsibility for the management of capital flows should be assumed by the private sector. As a counterpart, 'regular' IMF lending should move away from recent large packages, and strict limits to access to Fund resources (say to 300% of quota) should be reinstated. At the same time, a new

and large facility for emergency lending in cases of clear liquidity crises that are internationally widespread and of a systemic nature should be created.¹¹

This may be the direction in which the system will eventually move, but such proposals will first have to overcome a number of technical, economic and especially political obstacles. In the meantime, conditional lending will become more and not less important in a world of increasing capital mobility. And, although the creation of an international lender of last resort is not feasible in today's circumstances, a case can be made for a reinforcement of the role of the IMF as a provider of emergency lending. The world of globalized and volatile financial markets, however, raises the difficult question of the optimum design and size of a financial rescue package: large enough to reassure markets, not so large as to weaken the incentive for policy adjustment.

11 For an argument along these lines, see Lipton (1999). See also the forthcoming report of a special Task Force of the Council on Foreign Relations on international financial architecture.

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10. TAXATION AND THE ARCHITECTURE OF THE INTERNATIONAL ECONOMIC SYSTEM

Vito Tanzi *

1. Introduction

Over the past few years, as a consequence of the financial crises that hit Mexico, Indonesia, Korea, Thailand and some other countries, there has been a lot of discussion about the 'architecture' of the international financial system and the fact that the existing architecture needed some changes aimed at increasing transparency of policies, at providing more timely and accurate statistical information and at better regulating various sectors. Codes of good practices have been developed for fiscal transparency, for monetary and financial policy transparency and for other areas. A call has also been made by the G-7 to the relevant institutions to develop principles of good practice in social policy.

This chapter does not aim at discussing the faults of the existing architecture or the merits of the proposed changes to that architecture. It rather argues that the changes brought about by various aspects of globalization have increased the fragility of the existing tax systems and have

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created a need for some reform of the existing architecture -made up of international institutions, codes of conducts or good practices- and formal and informal agreements among countries -to deal with problems that are being faced and that will be faced with increasing intensity by the countries' tax systems. Because taxation is often a necessary or even an essential ingredient of government policies aimed at protecting the most vulnerable in society -or, at least, at promoting social policies- the new architecture of the international financial and economic system must not ignore the impact of globalization on tax systems. This chapter addresses this issue within the context of the developing architecture of the international financial and economic system.

2. Taxation in closed economies

Not too long ago tax policy had predominantly a national dimension. Policy-makers who considered reforming the tax system of their country worried about their political ability to do so; about the ability of the tax administration to cope with the changes; about the revenue impact of the changes; about their efficiency aspects; and about the effect of the changes on the prices of consumer goods and of assets. However, policy-makers did not give much thought to the international dimensions of tax policy. In recent years, as a result of globalization, the situation has changed and the international aspects of taxation have become much more important.

Many observers may not be aware that major features of current tax systems, such as personal income taxes, value added taxes, and social security taxes, largely developed, or became important, in the period around the Second World War. In that period, international economic relations were very different from today's. Let me briefly describe some of these.

a) Trade restrictions

The economies of many countries were relatively closed because of high import tariffs, quotas and other quantitative restrictions, and limited access to foreign exchange. Imports were subjected to high import duties or were even prohibited. In this environment the changes in the tax rates of other countries did not have much of an impact on the consumption or production patterns of a given country.

b) Limited capital movements

In many countries domestic currency could not be converted freely into foreign currencies and exporters had an obligation to sell their foreign currency to the central bank at rates that often implied high implicit taxes. The

official capital movements that took place were largely a consequence of foreign direct investment (FDI), while the capital flight that occurred took place through the manipulation of import–export prices and accounts. Thus, the unauthorized exportation of capital required time and was costly in an explicit or implicit way. Capital flight occurred on a large scale not because of actions by other countries, but because of economic and political developments within the Latin American countries.

c) *Mobility of individuals*

There was little mobility of labour except for migration which involved a permanent change of residence on the part of those who migrated. Few individuals operated internationally or earned income in more than one country. Most individuals received income from only one country and often from only one income source. Individuals also spent most of their income in the country in which they resided even though, of course, their consumption basket included some imported goods. The limitation in the mobility of individuals implied that countries were free to set income tax and sales tax rates without worrying about other countries' rates. This environment facilitated the task of collecting taxes and of pursuing an independent domestic tax policy.

d) *Portfolio investment*

Short-term capital movements were limited. In the 1970s, because of the great supply of petro-dollars associated with large balance of payments' surpluses on the part of oil-exporting countries, which resulted in a great deal of liquidity for banks in major financial centers. This lending led to an accumulation of foreign debt and, eventually, to the debt crisis of the 1980s. It was for the most part lending for specific and not very short periods of time. At that time, institutions such as *hedge funds*, capable of shifting large amounts of money across frontiers, within short periods of time, were still non-existent. The countries' policies, and the existing technology, would have made these operations difficult especially on a large scale. *Tax havens*, though already in existence, were not playing a significant role. They mainly assisted some individuals at evading taxes and at laundering money obtained from illegal activities.

The modern tax systems were developed in this environment. It should be recalled that the value added tax appeared in the 1950s and did not become popular until the 1970s. The modern version of the personal income tax -i.e. the progressive, global income tax, did not become a major source of revenue until the Second World War. Because of the embryonic state of public pension

systems, and because of fiscally-friendly demographic developments, social security taxes did not become important until more recent decades.

In the environment described above, tax competition between countries was almost non-existent, except for the provision of tax incentives for FDI and foreign trade taxes. Tax policies did not have an international dimension and policy-makers were free to choose their tax systems and the rates at which they levied their taxes without fear of repercussions from other countries. Many governments attempted to use the tax system to redistribute income or to finance welfare programmes. Thus taxes were a major component of social policy.

3. The impact of globalization on taxation

Especially since the early 1980s, because of policy and technological developments economies have become much more open. In many countries nominal tariffs have been sharply reduced and quotas and other quantitative restrictions to trade have become much less common.¹ The result of trade liberalization has been a large expansion in world trade. The recent slowdown in the rate of growth of world trade is likely to be a transitory development. Today the consumption basket of consumers contains far more foreign produced goods than 20 or 40 years ago.

A second trend has been the growing importance and role of multinational corporations. A large proportion of total trade among countries is now trade among different parts (branches or subsidiaries) of the same multinational companies. This aspect has major implications for the taxation of the profits of multinationals because it creates the possibility that corporations will show profits in their parts which operate in a low-taxed country. The multinationals have expanded their activities into manufacturing and, thus, away from the traditional exploitation of natural resources which in the past tended to make them enclaves without major links to the domestic economies in which they operated.

A third major development has been the growth of short-term capital movements. In the 1970s, most capital movements *not* associated with FDI took place in the form of fixed term loans by foreign banks. At times these loans financed largely unproductive public spending and allowed the borrowing countries to have large and growing fiscal deficits.

In the late 1980s, and especially in the 1990s, this picture changed dramatically. Capital movements were no longer limited to the two categories

1 On the other hand, impediments based on environmental, health, or social considerations may have become more common.

mentioned above but, to an increasing degree, came to reflect short-term loans to the private sector of emerging markets, including domestic private banks, and portfolio investments (stock or bond markets). This type of capital movement was made possible by changes in national policies, which allowed inflows that had been previously prohibited, and changes in technology, which made possible the transfer of information and of large sums of electronic money across countries within very short periods of time. Electronic money came to play an increasingly important role and made it possible the transfer of huge sums of money across countries in seconds (see Group of Ten, 1997). The new money went directly into stock markets, domestic securities and domestic banks; indirectly, it went into real assets including real estate and other investments. In Southeast Asia many luxury buildings, shopping centers, and other domestic investments were directly or indirectly financed by these short-term capital movements.

In this connection, the role of investment funds and hedge funds deserves special mention. The growing role of these institutions is a relatively recent development with still difficult-to-grasp implications. They have acquired enormous importance in recent years; their activities, strategies, and investments are kept secret, even though the capital that they control or influence through their actions can be very large. For these lenders, it is difficult to determine when income occurs, where it occurs and who has claims to it. Thus, it is very difficult for *national* authorities to tax the earnings of these funds especially when these institutions operate, as they often do, from off-shore centers and tax havens.

The combination of the large amounts of money invested (or, at times, even laundered) and the existence of many tax havens which are happy to provide shelters to these activities has created situations very different from those which existed in the past. The complexity of the international financial market and the lack of a clear national identity for the money invested or even for the institutions that make the investment, renders the regulation of these activities, under the current architecture of the international financial system, very difficult or even impossible. There is practically no regulation for hedge funds operating from tax havens and little for those registered in countries which are not tax havens. It is unlikely that these institutions contribute much to the tax revenue of the countries in which they operate.

A fourth major development is the growing ability of individuals to travel abroad and work, spend and invest in foreign countries. When 60 million tourists visit France in one year, about 10% of the population of Japan goes abroad, and many individuals work abroad without changing their tax address, it is clear that, economically speaking, national borders have become much less constraining than they used to be. This has made the task of tax

administrators much more difficult as it is far more difficult to tax activities that take place abroad than those that take place domestically.

The trends described above could not fail to have major consequences for national tax systems.

First, inevitably, *cross-border tax spillovers* have become common. A spillover occurs when the tax policy of one country has a significant impact on other countries. Spillovers imply that the tax policies of individual countries are no longer set independently of the tax policies of other countries but they take good account of those policies.

Second, *international tax competition* is growing in the sense that countries are becoming increasingly aware of the possibility that, through well targeted changes in their tax system, they may acquire a competitive advantage *vis-à-vis* other countries. For example, they may be able to export part of their tax burden by inducing foreign consumers to shop in their countries and foreign savers and investors to invest in their countries (see Tanzi, 1999; OECD, 1998a, 1998b). We have thus the beginning of the creation of an international tax base that just like the oceans' fishing grounds is seen as a 'commons' to be exploited by whoever can have access to it.

Closely associated with tax competition is what, in Europe, is often referred to as 'tax degradation'. The meaning of this term is a bit vague, but it broadly refers to the fact that globalization and tax competition may bring about changes in the tax system that make it less desirable either technically or politically. Countries are forced to make unwanted changes in their tax systems because of the action of other countries. For example, many Latin American countries feel that they cannot tax interest income because their citizens have the option of investing their savings in countries that allow tax free investment for these funds to foreigners. Or some countries have been forced to lower their taxes on cigarettes because their neighbours did, providing the citizens of the former country the opportunity to avoid the higher taxes.

Globalization, in all its aspects, and tax competition are likely to affect tax revenue by forcing many countries to cut marginal tax rates thus reducing the statutory progressivity of the tax system as well as tax revenue. A continuation of current developments is likely to lower the politically or technically sustainable tax burden for many countries, thus reducing the government's ability to maintain their level of spending without widening fiscal deficits. It is also likely to reduce the governments' degrees of freedom in using particular taxes. Economists who believe that governments tend to spend too much and spend inefficiently generally welcome this trend because it forces governments to cut spending and to reduce tax rates. Tax theorists may also welcome tax competition because it forces a lowering of taxes on

capital thus reducing welfare costs. However, policy-makers who are faced with what they consider inflexible spending obligations or large fiscal deficits, or who want to pursue some social objectives through the use of the tax system are concerned about the likely reduction in the level of taxation and their reduced discretion in the tax structure that they wish to promote.

The developments described above are also likely to increase tax evasion and, because of this, to reduce even more the level of taxation. For example, multinational corporations may use transfer prices, thin capitalization, strategic allocation of fixed costs among the parts of the whole enterprise or the arbitrary valuation of trademarks or other inputs for shifting profits from parts of the corporation operating in countries where tax rates are high to parts operating in countries where tax rates are low. Individuals who earn their income in foreign countries may not report in the tax declaration they present to their national authorities the income they earn abroad. Tax evasion also results from activities operating from tax havens and from the banking secrecy that exists in several countries.

In conclusion, the tax systems and the institutional arrangements that were largely created at a time when economies were closed, capital did not move and individuals did not travel much may become fragile in the new environment. Thus changes may need to be made to the international architecture that characterizes the existing systems to make them compatible with the new environment.

4. A world tax organization: an essential element of the new architecture

In this section I will sketch a major step that might be taken as part of the new architecture to prevent globalization from seriously damaging tax systems. I will assume that letting the market forces determine the final shape of tax systems and the level of tax revenue through tax competition is not a desirable alternative from a social point of view. Some will undoubtedly strongly disagree with this assumption. For discussions of steps that might be taken by individual countries to make specific taxes more resistant to the new environment the reader must be sent to other writings (see Tanzi, 1999, 2000).

It is interesting that now we have a world organization to deal with issues related to trade policy while we do not have a world organization to deal with issues of tax policy. The more successful is the World Trade Organization (WTO) in dealing with trade issues the more will countries compete with their tax systems. In different works, since 1988, I have argued that the time may have come when some sort of world organization responsible for dealing with tax issues may have become desirable. There are different possibilities for

setting up such an organization. A first possibility could be a world organization with the power to *impose and collect some taxes*. Although only time will tell whether such an organization will ever see the light of day, at this time this is not a realistic idea. The obstacles are great and are as much political as technical. Many powerful governments would simply not allow this development to take place, because such an organization would sharply reduce the power of nation states and of national policy-makers in a highly sensitive and political area. However, if such an institution existed it could play a key role in raising revenue for financing international public goods or for redistributing income on an international scale. The existing architecture does not have any element that promotes these objectives in a direct way.

Twelve years ago, before these issues became popular, I wrote that:

The 'information-revolution,' now well under way, and the large amounts of information on individuals that it has caused to be stored away in computers, may give governments tax handles, if they succeeded in getting access to it. The governments of various countries will increasingly need to share some of this information. *It is conceivable that the day may come when the countries create an 'International Revenue Service' to collect taxes that could not be collected by separate governments and to allocate them either to the provision for international public goods or back to the countries.* Such an international institution might also collect information on taxpayers for the benefit of the member tax administrations. (Tanzi, 1988, p. 277, italics added)

A less ambitious and more realistic proposal was made in my book on *Taxation in an Integrating World* (1995). It was developed more fully in Tanzi (1999). In this alternative proposal, I suggested that the time may have come to create a World Tax Organization that would: (a) exercise a surveillance function on tax developments in the whole world; (b) provide a world forum for discussing international dimensions of tax policy; (c) suggest solutions to arguments between countries about tax competition; (d) subject countries that try to earn free rides at others' expense -by, for example, introducing tax changes that are damaging to other countries- to moral pressure from other countries; (e) gather tax statistics; (f) inform countries about best practices; (g) develop a code of conduct for good behaviour in tax legislation and in tax administration; and so on.

Such an institution would *not* collect taxes and would *not* have the power to legislate tax changes in particular countries. Its role would be that of monitoring developments and attempting to develop common positions on tax issues while applying some power of moral suasion on countries that deviate from acceptable behaviour. In other words its role would be similar to that of the WTO in the trade area. Its main objective would be that of trying to make tax systems *consistent with the public interest of the whole world rather than the public interest of specific countries*. Because of the limited role of such an

organization, the countries' opposition to its creation might be less strong than it would be to an International Revenue Service.

If such an organization came into existence, it could promote some tax coordination among the countries of the world. By 'tax coordination', it is not meant that all countries of the world would have the same tax system or the same tax rates but simply that particular elements that lend themselves to tax competition could be discussed among countries. Without a tax organization on a worldwide scale, international agreements aimed at reducing potential tax competition would be more difficult to reach and the architecture of the world financial and economic systems would lack an important element.

5. The financing of international public goods

In recent years, there has been an increasing awareness that public goods or public 'bads' are not confined exclusively within national boundaries but, at times, they cross national borders -and, in particular cases, they may be of relevance to the whole world. This raises the question of how to deal with them. This is likely to become an element of growing importance for the international architecture.

Traditionally, the process of dealing, or not dealing, with international public goods has been as follows. For quite some time, there was a tendency to ignore them, perhaps under the assumption that they were not important -or, perhaps, not important enough to merit attention. When public goods, or more often public 'bads,' affected only two or a few countries -as in the case of acid rain, or river pollution- the assumption was that the countries would themselves deal with the problem by, for example, having the polluter subsidize the polluted or, alternatively, by having the (richer) polluted country pay for changes in the (poorer) polluting country that would reduce the pollution.

In cases where the public goods or the public 'bads' are truly international, in the sense that many countries or the whole world are affected, the common solution has been to deal with the problem through international agreements. This has been the case for dealing with chemicals that destroy the ozone layer or for dealing with global warming. These agreements have been difficult to reach, and in particular cases they may not be reached, especially when doubts exist about the efficacy of the suggested solution; or when the burden sharing among countries is not seen by some groups or some countries as being fair.

In some cases, dealing with public goods or 'bads,' may require not just regulations but financial resources or the use of taxes. Dealing with chaos or post-chaos situations may be an example in which (under the assumption that

the solution to these situations is an international public good) money is needed. Dealing with large and destabilizing movements of short-term capital being driven by herd instinct might be a situation in which taxation might be preferable to direct controls on those movements.

There is no doubt that as the world becomes more integrated, as many public goods (peace, clean environment, etc.) acquire an international character and as the solution to some of them requires financial resources, it would be useful to have revenue sources that did not depend on the willingness of specific countries to contribute to the needed amount. One can think of various tax bases that might lend themselves to the possibility of providing these resources. For example, taxes on globally polluting fuels and chemicals might be one possibility. However, the administrative, technical and political problems raised by these taxes would be formidable. In any case, it is unlikely that these developments might occur without some form of world tax organization.

The possibility of using Tobin-type taxes (Tobin, 1978) to provide resources to finance international public goods has received a lot of attention (see Ul Haq, Kaul and Grunberg, 1996). The standard argument for such taxes has been their ability to tax short-term and presumably speculative capital movements more heavily than long-term capital movements, thus discouraging large short-term in-and-out capital movement in particular countries without affecting long-run flows. Under the assumption that a well working international or financial system is a public good worth preserving, these taxes might play a useful function. Tax economists have not shown much enthusiasm for these taxes. However, if these or similar taxes have merit, their implementation would be more likely in the presence of a world organization responsible for tax surveillance.

6. Conclusions

In this chapter, I have sketched some of the issues that arise out of the realization that tax policy that used to be prominently national has, in recent years, acquired a progressively more international dimension. This development has many implications that deserve to be studied and analyzed in much greater depth than has been done in this chapter (see Tanzi, 1999, 1998 for more details).

The chapter has also introduced the issue of the growing importance of international public goods and the fact that there is no obvious mechanism today that assures that these goods will receive the attention that they deserve. For sure, when dealing with them requires money, the current arrangements almost guarantee that the necessary financing will not be there. In the context

of the creation of a new architecture for the international financial and economic system the time may have come for a serious re-thinking of these issues. Political sensitivities should not be allowed to prevent such a rethinking.

The communiqué of the G-7 Finance Ministers and Central Bank Governors that met at Petersberg, Bonn, on 20 February 1999, has a section on strengthening the international financial and monetary system. This section includes a long list of steps to be taken. The Annex lists 12 G-7 commitments, 17 tasks for the Fund and for other international institutions to carry out, and a listing of further work to strengthen the international monetary system. The last item of the Annex (point XXXV) asks for the 'encouragement of policies that protect the most vulnerable in society.' The whole communiqué is remarkable by its absence of any reference to the issues discussed in this chapter.

There are almost no elements of the developing architecture of the international financial system that address policies to protect 'the most vulnerable in society' or that address objectives such as equity and the financing of international public goods (such as peace, a good environment, a more equitable environment, absence of extreme poverty, and so on). As the Managing Director of the Fund has been saying, the developing international architecture needs a human face. It cannot be just an exercise in containing financial crises in emerging markets.

In a world where foreign aid has fallen dramatically, foreign debt remains high in spite of some recent attempts at reducing it for very poor countries, where commodity prices have fallen precipitously and where some international public goods are not receiving the attention and the financing that they deserve, some aspects of the developing architecture of the international financial system must deal with these issues. This chapter has proposed the creation of an instrument that may be useful in this context.

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PART II
NATIONAL POLICIES TO FACE VULNERABILITY

11. STABILIZING CAPITAL SURGES IN EMERGING ECONOMIES *

*Ricardo Ffrench-Davis ***

1. Introduction

Instability in the emerging economies of Asia and Latin America has been strongly associated to changes that have occurred in international capital flows over the last quarter of a century. During the 1970s, a large supply of funds was made available to many developing nations; then, during the 1980s, there was a generalized severe binding shortage of financing, and the Latin American region in particular became a net exporter of funds. Between 1991 and 1994, it received a large capital surge again, only to experience another sharp reduction focused in Mexico and Argentina, and a generalized drop of portfolio flows in late 1994 and early 1995. The so-called 'tequila crisis' was followed by a renewed access in 1996–97. In 1998–99, Latin America experienced a new shortage of external financing, aggravated by a worsening of the terms of trade. The crisis originated in Asian countries has now been the source of a new recessive macroeconomic adjustment in Latin America.

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On all those occasions, the changes in external financing were supply-led,¹ were first expansive and then contractionary and had a strong impact on the national economies on both sides of the cycle. Up to 1996, the successful emerging economies of Asia appeared to be immune to the instability associated with capital surges, as illustrated by their performance during the 'tequila crisis'. Recent events have shown that was not any longer so. Some of the causes are common to those of Latin America. The new crisis provides a renewed opportunity to significantly improve the architecture of the international financial system, and to reform the domestic approach so to achieve sustainable macroeconomic equilibria and to enhance their contribution to growth. Here we concentrate on some features of policies in fashion in emerging economies and suggest reforms needed.

Section 2 sketches the three capital surges experienced by Latin American countries (LACs) since the 1970s, focusing on the 1990s. Section 3 reviews the main macroeconomic effects generated by capital inflows, emphasizing the analytical bases. Section 4 compares the contrasted experiences of Mexico and Chile in the 1990s. Section 5 outlines features of Asian emerging economies shared with Latin American previous crises. Section 6 summarizes some policy lessons.

2. Three capital surges to Latin America

The growth of international capital markets since the mid-1960s is partly a reflection of the growth of the world economy, including international trade, and the globalization of production. But, it is also associated with purely financial factors, in which changes have occurred at a much faster pace. During the 1970s and the 1980s, many countries began to liberalize their financial sectors and to relax or eliminate foreign exchange regulations (Díaz-Alejandro, 1985; Devlin, 1989). This, together with the revolutionary advances that have taken place in data management and telecommunications technology, and the emergence of increasingly sophisticated financial techniques, contributed to a boom of financial flows.

Net capital inflows to Latin America averaged nearly 5% of GDP in 1977–81, 1991–94 and 1996–97. During all three periods, the deficit on current account rose sharply, and exchange rates appreciated (see ECLAC, 1995, 1999b); naturally, imports grew more rapidly than exports, and the stock of external liabilities rose steadily. Indeed, all these variables reflected a growing

1 There is well documented evidence showing that these changes have originated, to a large extent, in the sources of supply. See Calvo, Leiderman and Reinhart (1993); Culpeter (1995); Griffith-Jones (1998).

macroeconomic imbalance after a while,² in many cases anchored to one dominant 'balance': that of a falling inflation associated with real exchange rate appreciation and climbing external deficits. Those recipient countries which had larger deficits on current account, heavily financed with short-term liabilities and exhibiting stronger appreciating exchange rates, tended to become increasingly more vulnerable to external creditors,³ the outstanding case being that of Mexico in 1991–94. Creditors, given the high exposure of financial assets placed in the region, subsequently became more sensitive to any 'bad news'.

The dramatic increase of international financial flows in recent years has been more diversified during the current decade than it was during the 1970s. But the situation is potentially more unstable, inasmuch as the trend has been to move from medium-term bank credit to investment in liquid stocks, bonds and deposits; a very high percentage of this supply of financing is of a short-term and liquid nature. Paradoxically, there has been a diversification toward volatility in the 1990s; the relative improvement after the 'tequila crisis', with a rising share of FDI,⁴ still included a significant proportion of volatile flows.

There has been a long process in the 1990s of building a market for portfolio investment in emerging economies, with large flows in the process. Latin America was a receptive destination, and offered the expectation of high rates of return. Why the high rates of return? Naturally the rate should tend to be higher in the 'productive' sectors of capital-scarce emerging economies. Beyond that, several conjunctural factors reinforced that outcome. Initially, prices of equity stocks and real estate were highly depressed. That allowed a 300% average rate of return (in current US dollars) in the stock markets of Latin America between late 1990 and September 1994 (see Table 11.1), with fast rising price/earnings ratios. After a sharp drop around the 'tequila crisis', with contagion to all Latin American stock markets, between March 1995 and June 1997 average prices nearly duplicated, being pushed up directly by portfolio inflows.⁵ Domestic interest rates were high as well, reflecting the binding external restriction predominating in 1990 and the repressive

2 Actual significant disequilibria, in a framework of repeated statements regarding the need to maintain macroeconomic equilibria, reveal an inadequate understanding of how to achieve equilibria, sustainable and consistent with development. See Ffrench-Davis (1999, Ch. 6).

3 See our advice, as early as mid-1992, reproduced in Ffrench-Davis (1999, Ch. 9).

4 The well documented positive link between FDI and productive investment (see Ffrench-Davis and Reisen, 1998, Ch. I), was weakened by the fact that, as shown by ECLAC figures, about 40% of FDI inflows in 1997–99 corresponded to acquisitions of Latin American firms instead of creation of new capacity.

5 An outstanding feature of stock markets is that they contribute a notably low share to capital formation (for the United States, see Stiglitz, 1994). In Chile the issue of new shares in the local stock market represented in the peak years merely 4–6% of gross capital formation.

monetary policy in place (plus the short-termish bias of financial reforms implemented; see French-Davis, 1999). Finally, in a non-exhaustive list, the recovered supply of external financing generated a gradual exchange rate appreciation (see Table 11.2) that also encouraged additional liquid inflows, by dealers operating with maturity terms within the horizon of expected continued appreciation of the domestic currency.

Table 11.1
LACs: INDICES OF STOCK EXCHANGE PRICES, 1990-99^a

	Dec. 1990	Aug- Oct. 1994	Dec. 1994	March 1995	Dec. 1995	Dec. 1996	Jun. 1997	Dec. 1997	Dec. 1998	Dec. 1999 ^b
Latin America	24.1	100.0	80.9	58.6	66.4	76.9	106.2	96.2	59.4	85.9
Argentina	17.3	100.0	77.5	63.4	84.2	100.1	121.9	117.3	84.0	111.3
Brazil	11.7	100.0	91.6	67.4	71.3	93.1	143.2	112.1	64.3	90.2
Chile	25.9	100.0	100.8	94.9	97.9	81.0	105.3	83.8	58.6	75.1
Colombia	15.0	100.0	93.4	88.6	69.6	72.7	90.3	90.2	50.9	40.0
Mexico	30.0	100.0	62.6	32.7	45.7	53.7	68.7	78.4	47.8	82.7
Peru	-	100.0	104.8	87.4	114.6	115.4	156.8	131.4	79.2	95.8
Venezuela	170.8	100.0	91.6	75.0	62.6	145.2	191.8	179.0	86.2	72.6

Source: Indices based on International Finance Corporation, *Monthly Review of Emerging Stock Markets*, various issues.

^a Values at end of each period, expressed in current US dollars.

^b December 10.

^c Average of the seven countries considered, weighted by amount of transactions.

Table 11.2
LACs: REAL EXCHANGE RATE INDICES, 1983-99^a

	1983-86	1987-90	1991	1992	1993	1994	1995	1996	1997	1998	1999 ^b
Argentina	78.5	100.0	66.1	61.5	57.9	60.3	66.5	67.9	65.8	64.1	58.4
Brazil	117.2	100.0	97.2	104.9	97.7	85.3	69.5	64.5	63.2	66.0	98.6
Chile	68.8	100.0	100.2	96.6	98.7	97.2	92.7	87.8	80.7	82.1	86.6
Colombia	65.1	100.0	111.6	99.4	94.5	82.5	82.3	77.0	72.5	78.1	86.6
Mexico	96.0	100.0	81.0	74.7	70.8	72.7	107.2	94.5	82.8	83.2	77.2
Peru	136.4	100.0	55.4	54.6	59.9	56.6	57.1	55.3	54.1	55.2	60.6
LACs average (18)											
Weighted	97.4	100.0	88.7	88.2	83.8	79.2	80.9	76.5	71.4	72.2	83.1
Simple	85.8	100.0	100	98.4	98.0	96.5	95.1	93.1	88.2	87.5	90.0

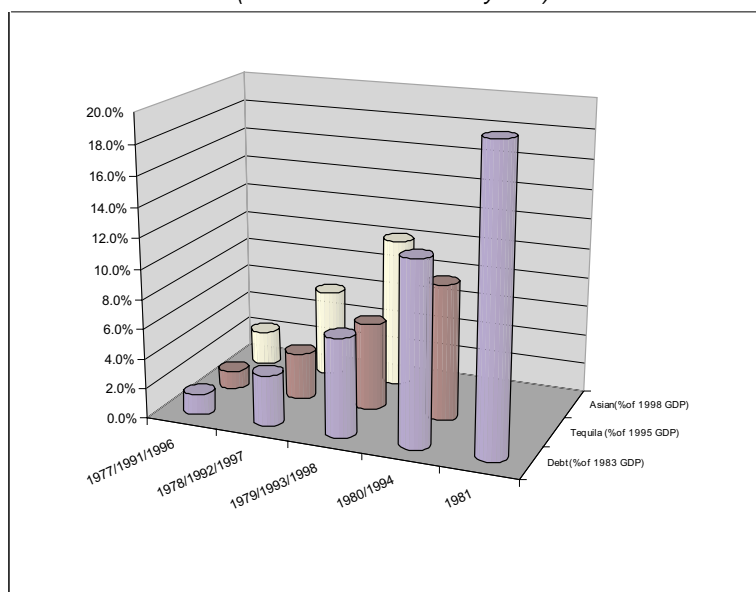
Source: Based on official figures processed by ECLAC for 18 countries.

^a Annual averages of real exchange rate indices for each country with respect to the currencies of their main trading partners, weighted by the share of exports to those countries; inflated by external CPI and deflated by domestic CPI; for Brazil we weighted the Rio CPI index (two-thirds) and the new official series of inflation (one-third).

^b January-September averages.

The deficits on current account rose persistently, and accumulated through time (see Figure 11.1). While in 1991 the actual stock of assets of the new investors in Latin America was evidently below the 'desired' stock, in 1994 it was notably large. We had entered a vulnerability zone, with the economy growingly sensitive to bad political or economic news. The longer and deeper the permanence in that zone, the lower the probability of getting away without a crisis.

Figure 11.1
LATIN AMERICA: ACCUMULATED DEFICIT ON CURRENT ACCOUNT
(as % of GDP in crises years)



Source: Calculations of the author based on current figures for 18 LACs.

3. The macroeconomic effects of capital surges

During the 1990s, capital inflows contributed to a recovery of economic activity, after the recession that still prevailed around 1990 in most LACs. When financial inflows recovered in the early 1990s, Argentina and Peru were two outstanding cases of capacity underutilization; in the opposite corner, the effective GDP of Chile and Mexico was close to their respective productive frontiers.

Annual GDP growth rose from 1.2% in the 1980s, to 4.1% between 1991 and 1994 and to 2.2% in 1995–99 (Table 11.3). This growth was meagre, however. On the one hand, the comparison with the previous golden age is shocking. In the three decades spanning 1950 and 1980, Latin America had averaged a GDP growth of 5.5% per annum; domestic investment had been rising fast, as a source of that vigorous growth. Subsequently, in the 1980s there was a sharp drop of investment, 7 points of GDP, with only a mild recovery in the 1990s (see Table 11.4). In fact, investment grew much less during this decade than did capital inflows; thus, a significant part of the external flows financed increased consumption, and consequently crowded-out domestic savings (French-Davis and Reisen, 1998).

Table 11.3
LACs: GDP, 1970-99
(annual growth rates,%)

	1970-80	1981-90	1991-94	1995	1996	1997	1998	1999 ^a
Argentina	2.8	-0.7	8.2	-5.0	3.6	8.4	3.9	-3.7
Brazil	8.6	1.6	2.8	4.2	2.8	3.0	0.0	0.5
Chile	2.5	3.0	7.9	10.1	7.3	6.9	3.1	-1.2
Colombia	5.4	3.7	4.3	6.2	2.2	3.2	0.7	-5.0
Mexico	6.7	1.9	3.7	-6.6	5.3	7.3	4.9	3.5
Peru	3.9	-1.2	5.3	7.7	2.4	7.7	0.1	3.0
Uruguay	3.0	0.0	5.2	-2.1	5.3	5.1	4.6	-2.5
Latin America (19)	5.6	1.2	4.1	0.4	3.5	5.3	2.1	0.0

Source: Calculations based on official figures for 19 countries processed by ECLAC; figures expressed in 1980 US\$ for 1970-80, in 1990 US\$ for 1980-97 and in 1995 US\$ for 1998 and 1999.

^a Preliminary figures.

Table 11.4
LACs: FIXED INVESTMENT RATIOS, 1977-98
(per cent of GDP)

	1977-80	1981-82	1983-91	1992-94	1995-98
Argentina	24.1	20.2	15.2	18.9	20.3
Brazil	29.2	24.8	22.5	19.5	20.7
Chile	13.9	15.3	15.4	20.9	24.7
Mexico	23.4	25.3	18.0	21.4	19.2
Latin America (19)	25.9	23.7	19.1	19.7	20.3

Source: ECLAC, figures scaled to 1995 constant prices.

Actually, the renewed financial inflows initially had a positive effect on Latin America: thanks to a larger utilization of installed capacity, GDP increased beyond the expansion of the production frontier: about one-third of the 4% rate of annual growth in GDP in 1991–94, corresponded to an increased use of capacity. The phenomenon was particularly intense in countries such as Argentina and Peru. Subsequently, the strong recovery of Argentina and Mexico in 1996–97 rested to a significant degree on the underutilization created in 1995. And, again, recovery was short-lived, giving way to slower growth after mid-1998 and open recession in Argentina in 1999. Any serious research should control for the huge swings in the rate of capacity utilization when measuring performance of policies, reform or productivity.

The increased availability of financing removed the binding external constraint that had been responsible for the one-decade recession of the region. However, beyond contributing to overcoming that constraint and to moving toward macroeconomic equilibria, after a while it led to an overshooting. Gradually, effective output approached the production frontier; gradually the initially depreciated exchange rates rose and at some point started to become ‘appreciated’,⁶ and so on in asset market prices. The accumulation of external liabilities (mostly liquid), made the economy more vulnerable to future negative external shocks.⁷ Tables 11.1, 11.2 and Figure 11.1 show a similar story in 1991–94 and 1995–97, reproducing the disequilibrating macroeconomic adjustments of 1976–81 (Ffrench-Davis, 1999, Ch. 4).

Why don’t debtors stop inflows before a crisis? Why don’t creditors do that task if debtors fail?

Among debtor countries we will distinguish three cases. Those with *nominal pegs* -the outstanding case being Argentina since 1991 with a currency board. Macroeconomic policy is passive and the conjuncture is determined by the external supply of finance. In an economy with huge underutilization of capacity and a capital surge, as was the case in 1991, passivity works well, until capacity approaches exhaustion or the surge softens or reverts; both coincided in late 1994. The outcome tends to be intrinsically procyclical.

A second case is that of a *flexible exchange rate*. Mexico had flexibility within an asymmetric band, and allowed it to operate under the capital surge. The actual rate remained at the most appreciated extreme of the band. The outcome was that Mexico shared with Argentina a significant real

6 It should be recalled that several LACs were implementing sharp liberalization of import regimes *pari passu* with exchange rate appreciation. See Ffrench-Davis (1999, Ch. 3); ECLAC (1995, ch. V).

7 The process was similar to that in several East Asian countries, with a capital surge-cum-financial liberalization since the early 1990s. See Ariff and Ean (1999).

appreciation, but Mexico had no underutilization of capacity, so the capital surge leaked to a much larger degree to imports and deficit on current account (Ros, 1999). The outcome is again procyclical. The standard assertion that exchange rate 'flexibility' can avoid disequilibria is at least misleading.

The third case corresponds to *comprehensively active macroeconomic policies*, of which Chile was the paradigmatic case in the first half of the 1990s, with an anti-cyclical outcome (section 4 below, and Agosin and Ffrench-Davis, 2000).

In the majority of cases, authorities allowed the capital surges to move into their domestic economies, as illustrated by the data in Tables 11.1 and 11.2.⁸ Most of them thought should do nothing or could do nothing, or preferred to 'benefit a little longer' from the anchoring of the domestic CPI to international inflation.

Ex post, the consensus of observers was that disequilibria had been built. For a voluntary flow to take place there is need of willingness by both debtors and creditors. Then, why did creditors not act in due time to curb flows? The specific nature of agents prevailing in the creditor side is crucial. The conflicting segment of flows, that was predominant in the surges and busts, naturally works with short horizons.

When creditors discover an emerging market, they start out with non-existent exposure. Then they generate a series of consecutive flows which accumulate in rapidly increasing stocks. As already said, the creditor's sensitivity with regard to 'bad news' increases significantly with the level of stocks placed in a country (or region), and with the degree of dependence of the debtor on additional flows (current account deficit plus refinancing of maturing or liquid liabilities). Additionally, the most relevant feature is that after a significant increase in asset prices and exchange rates, accompanied by rising stocks of external liabilities, the probability of reversal of expectations about their trend grows steeply.

The accumulation of stocks and a subsequent reversal of flows can be considered to be a 'rational' behaviour of individual suppliers, given the nature of predominant agents on the supply side.⁹ Investors with short horizons are not concerned whether (long-term) fundamentals are being worsened with capital surges while they continue to bring inflows. What is relevant for them is that the crucial indicators – real estate, bond and stock prices, and exchange rates – can continue providing profits in the near term; thus, they will continue pouring in money until expectations of near reversal

8 Lax or poor prudential supervision of banks obviously feeds disequilibria. But a strong supervision does not per se avoid the problem. Actually, a significant share of inflows is usually not intermediated by banks. As well, in the booms, prices of guarantees are biased upward.

9 Beyond that we face the issues of herd behaviour, transborder contagion and multiple equilibria.

start to build. It is quite relevant that in the three surges, spreads in loans kept falling while the stock of liabilities was rising sharply: for five–six years in the 1970s; three–four years before the ‘tequila crisis’, and a couple of years after that crisis. This implies a downward-sloping supply, which is a destabilizing feature.

The most relevant issue is that ‘myopic by training’ agents, specialized in microfinance have come to determine the macroeconomic conjuncture and policy design (see Pfaff, 2000). The outcome, unsurprisingly, turns to be unsustainable macroeconomic imbalances, ‘wrong’ or outlier macroprices, and an undermined environment for productive investment (particularly in tradables). Then, what is ‘irrational’, and evidently inefficient for resource allocation and total factor productivity is that the domestic macroeconomy has come increasingly to be strongly influenced by experts in microfinance. There is need for macroeconomic authorities to take over their responsibility of making fundamentals prevail so to achieve macroeconomic balances that are both sustainable and suitable for growth. That requires that they avoid entering vulnerability zones during economic booms-cum-capital surges.

4. The contrasting cases of Mexico and Chile in 1990–95

Chile and Mexico were considered ‘stars’ by financial markets in the early 1990s. Both faced a large supply, but chose divergent domestic policies with respect to inflows.

a) *The ‘tequila crisis’¹⁰*

The Mexican crisis which exploded in 1994 is a good example of the harm that can be caused when a country absorbs an excessive volume of capital inflows, giving way to a large stock of external liabilities, especially when the composition of such financing is short-term or liquid. Producers and consumers adjusted to a level of overall expenditure that increasingly became much higher than potential GDP, between 1990 and 1994;¹¹ the exchange rate appreciated significantly and the external deficit rose sharply. Thus, there was a maladjustment that would most likely have to be reversed in the future. Since the public sector was balanced, the disequilibrium was located in the private sector; after a while the amounts involved became unsustainable.

10 For a recent comprehensive analysis, see Ros (1999).

11 Despite the fact that expenditure exceeded GDP by 8% in 1992–94, production capacity was probably larger than actual GDP, with capacity underutilization in importables and exportables owing to an excessively appreciated exchange rate. This, together with NAFTA membership, might explain the subsequent sizable response of the output of tradables to real devaluation in 1995.

Then, a sharp cutback of financing on the part of creditors forced Mexico into a highly recessive adjustment and a huge devaluation, despite the large package of international support it received in 1995 (Lustig, 1997). A 6.6% drop in GDP and of nearly 30% in capital formation occurred in Mexico in 1995.

It is wrong to say, as it is said surprisingly often, that the Mexican crisis of 1994 could not have been foreseen because of the concealment of information. While it is true that official information on international reserves was provided only sporadically, the key data concerning the exchange rate appreciation, the high current account deficit and the fact that it was financed with volatile resources, were available on a regular basis. Notwithstanding this, by 1993 praise of Mexican policies was generalized in financial institutions and media, enhanced by the incorporation of Mexico in two clubs of rich nations, NAFTA and the OECD, in 1994.

However, the crucial problem was that neither those on the supply side nor those on the demand side paid enough attention to the available information until after the crisis erupted. Indeed, we must emphasize that for the most influential financial operators the more relevant variables are not related to the (long-term) fundamentals but to short-term profitability. This explains why they may suddenly change their minds radically about the economic situation of a country whose fundamentals remain largely unchanged.

In 1995, the Mexican crisis did not have a widespread effect throughout the region, as it had in 1982. The Argentine economy, however, was seriously affected by the contagion. Although this did not lead to a currency crisis in the sense of a sharp exchange rate devaluation, as many operators had feared in 1995, Argentinean GDP fell by 5% and investment diminished by 16%. The overall growth rate of Latin America went down sharply, to a figure below the population increase, while the regional investment ratio also fell substantially. During 1995, in diverse countries, negative flows were observed in several segments of the supply of funds (especially bonds, deposits and to stock markets).

Subsequently, the flow of funds reactivated once again, exceeding US\$ 80 billion in 1997, contributing to a 5.3% GDP growth (with 1994 the two largest since 1980). However, some of the same problems displayed in the 1991–94 recovery reappeared in 1996–97, and actually collected a bill in 1998–99. Nevertheless, the adjustment starting in 1998 took place in economies with a more moderate stock of volatile liabilities than in 1995, with healthier banking portfolios,¹² and with less overheated economies (see Ffrench-Davis, 1999,

12 After the banking crisis of Mexico and Argentina, following the 'tequilazo', these and other countries introduced reforms to their financial reforms which strengthened banking prudential regulation and supervision.

Ch. 10). However, ultimately, the Asian crisis caught Latin America after most LACs had appreciated their exchange rates and their deficit on current account had risen. The same old story was returning to the scene, in circumstances where the international scenario was recessive, with worsened terms of trade, declining growth of trade and of access to finance and rising spreads.

b) *Chile, against the trend in 1990–94*

Chile displayed a performance opposite to that of Mexico in 1995–96, regardless of numerous similarities during the years prior to 1994. However, there was a most pronounced divergence in macroeconomic policies, related to the external sector. In 1991–94, Chile and Mexico chose divergent roads with respect to capital movements regulation, exchange rate policy, and prudential supervision of the financial system.

Towards the end of the 1980s, both countries had already opened up their trade considerably, their budgets had improved substantially, privatization was well under way, annual inflation was around 20%, and the two countries had similar domestic savings rates. The reason why Chile performed better in 1995 is that, faced with an abundance of external funds in 1990–94, it deliberately followed a cautious policy (Agosin and Ffrench-Davis, 2000). Instead of taking and spending all the large supply of external resources available, which would have led to a significant appreciation of the peso and to a rising deficit on current account, it chose to discourage short-term capital inflows. In 1991 a tax was imposed, and substantial non-interest-bearing reserves for external credit were required; the reserve requirement was subsequently extended to foreign currency deposits and investment in second-hand stocks, while primary issues and venture FDI capital were kept exempted;¹³ FDI had to be held in Chile for one year at least; the financial system was subject to relatively strict prudential regulation, including a selective supervision of assets and required provisioning, as well as restrictions and drastic penalties on operations with related parties. The set of measures adopted effectively discouraged speculative capital inflows (Larraín, Labán and Chumacero, 1997; Agosin, 1998; Agosin and Ffrench-Davis, 2000).

As a consequence, by late 1994, Chile had a moderate external deficit, high international reserves, a manageable short-term debt, a domestic savings rate that was rising instead of falling (the latter being the case in Mexico and

13 The rate of the reserve requirement, that had to be kept at the Central Bank for one full year, was reduced from 30% to 10% by the end of June 1998 and to zero in September, in order to accommodate to the new shortage of external financing associated with the Asian crisis. Authorities, including President Frei and the President of the Central Bank, have reiterated that the policy tool is available for the next capital surge. See Frei (2000); Massad (2000).

Argentina), a level of domestic investment that since 1993 has been the highest recorded in history (Table 11.4), and an exchange rate in 1990–94 comparatively closer to equilibrium (Table 11.2) than that of most LACs, as reflected by a moderate deficit on current account.

Policy was effective in achieving its targets in most of the 1990s. However, in 1996–97 this policy mix and the intensity with which it was applied remained unchanged, in spite of a new vigorous capital surge to most countries in the region, but particularly to Chile, a country immune to the ‘tequila’ contagion. This surge should have been met with increased restrictions on rising inflows. Being a market-based mechanism, that alters relative prices of capital flows, what happened was that inflows came in paying the cost of the reserve requirement, with no evidence of significant evasion.

As a consequence, despite heavy intervention in foreign exchange markets by the Central Bank, a sharp real exchange rate appreciation and rise of the deficit on current account took place. Nonetheless, the benefits of the active regulation implemented in previous years had left large international reserves, a rather low stock of foreign liabilities and a small share of volatile flows. Unfortunately, those strengths were partially undermined by the excessive exchange rate appreciation and high deficit on current account recorded in 1997.

The Asian crisis has been felt principally through trade. The fact is that the terms of trade of Chile worsened in the equivalent to 3% of GDP (in 1998 current prices), with reduced access to external markets, in a country that was selling one-third of its highly commodity-intensive exports in Asia.

5. Emerging Asia in the 1990s: the new casualty of financial instability

During 1995 there were negligible effects of the ‘tequila crisis’ over the Asian region. This was so even in economies with large deficits on current account. As a consequence, 1996 saw many outstanding researchers and observers asserting that deficits were not relevant if investment ratios and economic growth were high.

Several Asian countries had regulated capital inflows and foreign exchange markets successfully for long periods (see the cases of Malaysia, Indonesia and Thailand, in Sachs, Tornell and Velasco, 1996; Korea and Taiwan, in Agosin, 1999). Growth was actually sustained and extremely high. In 1980–95 GDP yearly growth averaged between 6% and 8% in Korea, Indonesia, Malaysia and Thailand; the investment ratio exceeded 33%, with domestic savings ratios close to that notable level; inflation was low (in the 5% annual range) and fiscal budgets were generally balanced or in surplus. In the

meantime, the average GDP growth in Latin America was 2% and the investment ratio fluctuated around 20%.

What explains the sudden worsening in Asia?

First, what works for some time might see its efficacy reduced after a while. A relevant feature relates to export performance. In fact, the exports of several Asian economies were experiencing problems. What had been until then products with a notably dynamic demand appeared to be reaching maturity, facing tightening markets (Radelet and Sachs, 1998).

Second, even if exports behave well, a disequilibrium can emerge if imports experience a boom. In both Korea and Thailand imports rose sharply in 1995–96. This boom was related to expanded aggregate demand and to cheaper imports (owing to some import liberalization together with relaxation of liquidity constraints to consumers and exchange rate appreciation, a *Latinamericanization* of some Asian economies), all led by capital surges.

Third, good sustained policies can be reversed under exogenous pressures. The strong drive towards financial liberalization prevailing in the world had also permeated several Asian economies in the 1990s (Jomo, 1998; Agosin, 1999; Ariff and Ean, 1999); China and Taiwan were two outstanding exceptions. Actually the deficits on current account increased substantially in Korea and Thailand since 1993. Data shows that they were not led by public deficits and did not imply losses of international reserves. Neither were they due to an exogenous increase of private expenditure. On the contrary, the cause was a private expenditure rise led by mostly short term capital inflows (IMF, 1998; Radelet and Sachs, 1998); a fast-rising firms' leverage and dollarization of liabilities (Krugman, 1999). In Korea, Indonesia, Malaysia and Thailand international reserves were accumulating persistently between 1992 and early 1997, fed by capital inflows: international reserves more than doubled in that period.

Inflows contributed to a domestic lending boom, with bubbles in real estate and stock market prices. Weaknesses in prudential supervision of the financial system, not so relevant in the previously repressed domestic markets, became evident with liberalization and the lending boom. But it is also evident that poor supervision was not the main cause, but just a reinforcing factor in the macroeconomic disequilibria which was built in just three years, in a region that had exhibited a spectacular performance for a long time.¹⁴

14 Actually, a significant share of inflows was not intermediated directly by financial firms. In the 1970s also nearly half of bank loans had arrived to Chile to non-financial firms, notwithstanding the lax regulation of domestic banks.

It was a phenomenon of worsening macroeconomic fundamentals, led by a capital surge, which sustained appreciating exchange rates (though a moderate trend) and a strongly increased aggregate demand (with a significant enlargement of the deficit in current account of 5 points of GDP in Korea, 2 points in Indonesia and 3 points in Thailand). The disequilibrium was recognized by financial markets only in 1997 and implied high economic and social costs in 1998. The policy failure was an error shared with the rather similar financial reforms of Chile in the 1970s and of Mexico in the 1990s.

The East Asian countries experienced deep recessions in 1998. Subsequent to decades of solid annual GDP growth of 6–8%. Indonesia exhibited a 14% recession, similar to the spectacular drop of Chilean GDP in 1982. For Korea, Malaysia and Thailand reductions of 5–8% were recorded. Korea recovered during 1999 faster than the other countries of the region. Notwithstanding that Korea exhibited an impressive external surplus and GDP growth in 1999, the costs were significant: in 1998–99 a GDP nearly 14% below the historical trend and a drop of 20% in investment in 1998. These recessions are comparable to those of Latin America in 1982–83 (though shorter-lived), with drops in productive investment, banking crises and social decline.¹⁵

6. Policy lessons

Optimism regarding Latin America had returned to the international financial markets in 1996–97. Net capital inflows had climbed well over the pre-crisis levels. Composition improved, with a larger share of FDI. A dynamic GDP growth for the region as a whole was observed from mid-1996 until mid-1998. GDP recovery in Argentina and Mexico was particularly vigorous: with the sharp drop in both countries in 1995 there was a large gap between effective GDP and productive capacity. This enabled a significant re-activation to take place, leading to a complacent view of the effects of crises and of the capacity to recover. Nevertheless, in both countries GDP *per capita* during 1997 was approaching only the levels achieved in 1994, while in Mexico average wages were still 22% lower in 1998 than in 1994. Costs for the real economy and equity are large and long-lasting.

Since the GDP increase comprised a large recovery share, effective GDP was once again close to the production frontier. However, the frontier moved upward slowly, because productive investment was still low, while real exchange rates were again taking an appreciation path. Consequently, as long as productive investment did not increase substantially, that rate of growth

15 See various interpretations of the Asian crisis in Perry and Lederman (1998); Radelet and Sachs (1998); Reisen (1998); Stiglitz (1998); Wyplosz (1998); Krugman (1999)

was not sustainable. In effect, at the beginning of 1998 it was foreseen that the 5.3% growth of 1997 would moderate to around 4%. With the intensification of the Asian crisis and its contagious effects, on finance and trade, the effective growth contracted to 2.1% in 1998 and closed near zero in 1999 (Table 11.3). Then the region experienced a new significant adjustment. The following lessons can be derived from recent experiences.

a) *On sustainable volume, composition and uses of capital flows*

It is important to ensure that the volume of inflows is consistent with the absorptive capacity of the host country. Absorption must, of course, refer to use in productive investment. The composition of flows has relevant incidence in three dimensions. First, FDI (excluding acquisitions of existing assets) goes directly to capital formation, as well as long-term loans to importers of capital goods. Second, volatile flows tend to impact the foreign exchange and stock markets more directly, and are weakly associated with capital formation which requires long-term financing. Third, the capital surges or deviations from the trend also tend to leak toward consumption, because of the faster capacity of consumers to respond as compared to irreversible productive investment. There is growing evidence that the greater the instability of flows (or deviation from the trend), the lesser the share directed to productive investment (Uthoff and Titelman, 1998).

Allowing too much to drain off into 'investment' on the stock exchange and consumption of imported goods, will create bubbles and imbalances that tend to be unsustainable. Particularly, fast rising stocks of net liquid external liabilities have a higher propensity to vulnerability (Rodrik and Velasco, 1999).

The recent experience has shown dramatically that allowing the market, dominated by agents with short horizons, to determine the volume and composition of capital flows can have a high cost for the recipient emerging economies. This is why the microeconomic costs associated with the use of regulations on capital inflows should be balanced against the social benefits in terms of macroeconomic stability, investment and growth (Williamson, 1993; Ffrench-Davis and Reisen, 1998; Zahler, 1998). Effective and efficient regulation is possible, with higher and sustained GDP growth; Chile proved this from 1991 to 1996 (Agosin and Ffrench-Davis, 2000).

b) *Avoiding outlier prices and ratios*

Governments must ensure that capital flows do not generate atypical (outlier) prices or significant distortions of basic macroeconomic indicators, such as interest and exchange rates, aggregate demand, the composition of expenditure in terms of consumption and investment, and the production of tradables.

Capital surges should not be used for achieving an extreme objective related to a single domestic economic variable, such as to anchor inflation, by appreciating the real exchange rate. This tends to throw other major variables off balance. It is risky to remain bound to a fixed nominal rate, and worst to fully dollarize except if our economy is an optimum currency area with the United States. Is there anyone in the region? The methods of regulating the exchange rate can be extremely diverse; several of them involve some form of a crawling-band, with some type of intra-marginal intervention (Williamson, 1996).

c) *Selective sequencing and flexible macroeconomic regulation*

Across-the-board opening-up of the capital account has been premature and should have been postponed, moving only in a selective way, until a long-term process in which other major reforms had been consolidated and new equilibrium prices had been established. The lesson to be learned from this experience is that during structural adjustment, with open capital accounts (especially when international financing is abundant) the capital flows can increase too fast and have destabilizing macroeconomic and sectoral effects. Externalities and other imperfections of international capital markets give rise to frequent cycles of abundance and shortage of external financing (McKinnon, 1991; Williamson, 1993; Wyplosz, 1998).

First, many emerging economies conducted deep trade reforms in the 1990s *pari passu* with exchange rate appreciation. That real revaluation obviously tends to distort the allocation of investment, seriously weakening the structural mid-term objective of penetrating external markets with new exports (ECLAC, 1995; World Bank, 1998; French-Davis, 1999, Ch. 3). Second, if productive investment capacity reacts with a lag and domestic financial markets remain incomplete and poorly supervised, capital surges cannot be absorbed efficiently in the domestic economy and they thus threaten the future stability of the flows themselves.

An inflexible commitment to indiscriminately opening the capital account is unwise, particularly in light of the crucial importance of macroeconomic stability, along with the disproportionate volume of the international capital markets compared with the small size of LACs markets. As long as market movements depend to a significant extent on short-term transactions and domestic securities markets remain shallow, there will be a risk of great instability in this new modality of linkages with the global economy. In fact, recent critical experiences of Mexico, Korea and Thailand attest to the wisdom of discouraging the accumulation of large short-term financial liabilities. That can best be faced with domestic prudential macroeconomic regulations, suited to the intensity of the supply of funding.

d) *International environment for a more efficient and balanced globalization*

The 'governance' of domestic and international financial markets is at the core of the future of the world economy. A common factor in recent crises has been the great volatility of the most rapidly growing segment of international financial markets: short-term and speculative funds. Successive waves of over-expansion, followed by financial panic, indicates that the market tends first to grow overshootingly and then to contract more than is justified by economic fundamentals. These features are inconsistent with a balanced and efficient globalization. More energy is being spent on resolving crises than on avoiding them. It is to be stressed that while there has been an obvious lack of appropriate prudential regulation of domestic financial markets in most of the emerging economies affected by the crises, there has been an even more notorious lack of appropriate international institutions to monitor such a sophisticated, but unstable, financial market.

It has been the predominant practice, in times of booming flows, for recipient countries to be praised and encouraged by the international financial institutions (IFIs) and financial specialists to accept all the resources offered. The typical situation has been that gradually the cost of financing has fallen during the boom period; then, the market has actually operated with a negative sloping mid-term supply of funding. The recriminations concerning the resulting excessive indebtedness have come later, partly from these same sources of praise, in the periods of massive outflows. There is an obvious contradiction between these two attitudes.

Financial operators evidently fulfil a useful microeconomic function as intermediaries between savers and users of funds, as hedgers of risk, and as providers of liquidity. However, in practice, perhaps without wishing to do so, they have come to play a role that has significant macroeconomic implications. With their herd-prone expectations, they have contributed to intensify the financial flows towards 'successful' countries, thus facilitating continuous rises in financial assets and real estate prices, and sharp exchange rate appreciation in the recipient markets. Apart from the poor quality of prudential supervision in these markets, these macroeconomic signals contribute to prolonging a process that appears, wrongly, to be efficient and sustainable (with good profits and loan guarantees, supported by high stock prices and low value in domestic currency of debt denominated in dollars). But in reality bubbles are being generated, which sooner or later must burst. When that happens, signals and risk ratings are reversed, in a sharp procyclical fashion.

In closing this chapter, we would like to emphasize that the focus of attention should be the management of booms, rather than crises; usually, the latter are the consequence of badly managed booms (ECLAC, 1999a; Ocampo,

2000). Given that existing institutions and instruments have been ineffective in warning of impending turbulence and rather have tended to encourage unsustainable booms, it becomes particularly relevant the design of an appropriate domestic regulatory framework and prudential macroeconomic policies, aimed at controlling booms before they become unsustainable. Noteworthy among such measures are the reserve requirements on financial inflows that Chile used with success in times of capital surges.

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12. AN ASIAN PERSPECTIVE ON THE DESIRABLE INTERNATIONAL FINANCIAL ARCHITECTURE

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1. Introduction

Human nature is subject to misjudgement, and economic calculation is no exception. Economic agents try to optimize, or at least 'satisfice' in the Simonian sense, but owing to imperfect as well as incomplete information and to limited processing capacity of information, their activities are always subject to errors. Since market participants often regard the market as 'divine', they tend to expect that the market will 'forgive' their errors. But the market can at most correct their errors, and if it does, not instantaneously. And, unlike salvation, when correction occurs, it brings about pain to participants.

Before the collapse of a nation's currency, there is a coincidence of errors between lenders and borrowers. Since 'it takes two to tango', it takes at least two parties to a loan contract to agree on a potentially delinquent loan. The role of the market is often supposed to correct errors by giving its proper signals to economic agents (Hayek, 1949). But it often sustains incorrect beliefs and even magnifies the incidence of errors, as is observed in many instances of bubbles in financial and currency markets.

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Once the market manages to correct the errors, there will be a collapse of the bubble, a sudden revaluation of currencies and a sudden reversal of funds (see Radelet and Sachs, 1998). Then begins the task of retrieval, readjustment and reconstruction. Since there are many studies on the causes of financial collapses, in this chapter I shall focus mainly on the adjustment process after a collapse. I will emphasize my perspective looking out of Asia.

First, I will discuss the sources of Asian growth as well as of Asian financial setback. Then I will describe one of the technical reasons why the currency crisis took place -that is, the practice of pegging a home currency to the dollar in a multicurrency world. Then, I will report some of Japan's attempts to take financial leadership in Asia; finally, I will give my personal opinions on the Asian Monetary Fund and the Miyazawa Initiatives.

2. The causes of the miracle as the causes of the crisis

Until a few years ago, the Asian region was a centre of economic wonder. Like a group of geese flying after each another, as Kaname Akamatsu put it, countries were taking off, in turn, from poverty. East Asian countries followed the rapid growth path of Japan, and then South East Asian countries followed them. During the 10 years between 1986 and 1995, Taiwan, Korea, Hong Kong and Singapore (the Newly Industrialized Economies, or NIEs) grew in terms of real GDP at about 8.1%, and Thailand, Malaysia, Indonesia and the Philippines (The Association of East Asian Nations, or ASEAN) grew at 7.5%, comparable to the high-growth period in Japan in the 1960s. The World Bank called this the 'East Asian Miracles'.

Krugman (1994) criticized the statement that the Asian growth did not entail an increase in total productivity but was merely the result of increased employment. If you consider the fact that so many countries suffer from underemployment of resources, particularly of labour, growth without total productivity growth but with input growth is nothing but a blessing. Compare a typical African city that is struggling for more employment with a typical Asian city! Whenever I view huge works of construction in an Asian city, I wish that the Asian miraculous growth had continued. After 1997, Asian economic miracles turned sharply into Asian economic crises. Symbolically, many buildings turned into unfinished ones. Many of the reasons for this unfortunate change can be found in the reasons for the past success itself.

Let us first sketch some of the secrets of success. To achieve a high growth performance, the labour force with its improved quality and education level was provided in this region by its strong family values often influenced by the Confucian ethic. Capital accumulation was facilitated by the high savings rate. Moreover, capital accumulation exceeded their own high savings in

many countries, though a notable exception was Taiwan and more recently China. They invited foreign capital in terms of foreign direct investments (FDI), as well as portfolio capital and short-term borrowing. This could have been the short cut to prosperity if everything had gone well. The World Bank volume endorses, though cautiously, the possibility of beneficial effects of government interventions in the form of industrial policy.

Another source of success was the fact that people were optimistic about the future, and forward-looking in terms of entrepreneurial adventures and investment. Some optimism is always desirable. In many Asian nations, however, these expectations were carried so far that the economies were fuelled into bubbles. Foreigners were also tempted by the bubbles and invested a large amount of capital, in such a way that a high growth was accommodated by foreign capital flows. Lenders as well as borrowers were misled by a common human error, myopic optimism.

Suddenly, expectations were betrayed. Then the crisis exploded. Like a Sumo wrestler who stretches his body and its centre of gravity too high, Asian economies were caught in an unstable situation. All the elements that had helped their rapid growth became obstacles to these economies.

In any society, economic surprises and miscalculation are a matter of course. Any economic system should be prepared to deal with consequences of unexpected changes in circumstances and wrong expectations. Under normal circumstances, the effects of miscalculations and malfunctions of the market system will be restored to normal by a proper choice of macroeconomic policies. If the shocks are too severe, the system does not necessarily return to normal. If the expansionary monetary policy to create bubbles is reversed, the economy may soon be stabilized. But normal functioning of banking and financing will be impaired. Chains of financial intermediation are broken. The cost of unemployment is high, and if the government wishes to encourage demand by relaxing macroeconomic policies, the effect of recovery works very slowly. Thus the process becomes irreversible. This may be the case for Indonesia, Thailand and probably for Japan. I do not mean that these economies are irrecoverable, but that the process of recovery will take a much longer time than the process of collapse. This kind of irreversibility or non-linearity is worth attention.

There were elements that made the situation worse. First, a high saving rate implied that the country was sacrificing present consumption for the sake of future consumption. The high investment ratio, often in excess of the saving ratio with the help of foreign capital, was the result of the forward-looking attitude; therefore it should usually be appreciated. When this forward-looking attitude turns out to be a consequence of unwarranted euphoria, then a painful process of adjustment must follow.

Compare these troubled countries with the Philippines, now a more stable economy. It has a lower propensity to save. In 1997, the savings/GDP ratio of the Philippines was 19.2%, while the same ratios for Korea, Indonesia and Thailand were, respectively, 34.5, 31.0 and 31.0%. One is astonished by huge shopping malls in Manila that signify the consumption orientation of the country: I used to think that the country was not growing because of Catholicism (though this may be politically incorrect thinking)! Now the country is stable, partly because consumption demand is generally the most solid component of national expenditure. Another stable country, Taiwan, has a relatively low saving rate, 24.7%.

The investment component is more volatile than the savings component. If a nation can borrow a substantial amount, the expansion of investment becomes easier. When expectations of the future are correct, a borrowing opportunity is always beneficial. If both the borrowers and the lenders become overoptimistic, the existence of leverage opportunity will magnify difficulties.

Second, business organization and intervention by industrial policy could not help avoid a financial crisis. Japanese-type management helps productivity promotion by a group of people. The main bank-type financial network may also facilitate better communication and information among groups of firms. The government may support such forms of management and financial relations; however, they are suitable for production schemes and commodity trade (*shosha*) networks, and not for high-tech and individual entrepreneurial activities -for example, in financial markets. The Japanese Ministry of Finance used to control what types of financial instruments traders could trade. The strength of Asian organizations for physical production did not necessarily help in the struggle against speculative attacks. Even after their miraculous growth, most Asians are not prepared to cope with highly technical and extremely shrewd speculative activities like those operated by George Soros. Weak points of the Asian economy were exposed and tested by the cruel logic of market.

To repeat, people miscalculate as a matter of course. And in the market economy, those who miscalculate are duly punished by the loss of profits. It is also natural that a national economy overexpands for a while and then experiences a period of setback.

A certain degree of setback is thus in a sense a healthy reaction of the economy. The problems are that the downturn of the economies is so steep and continues too long. After two-and-a-half years of hardship in these countries, some finally felt that they hit the bottom of the trough. Some still do not experience any feeling of recovery.

Let me finish this section by discussing aspects of microeconomic behaviour. Any society is hardly viable without market mechanisms, though no economy can be completely free of non-market transactions and communications. Indeed, 'crony capitalism' is an inefficient mechanism -I tell students who cooperate unduly on their exam papers that they are practising crony capitalism! State interventions can be efficient if the government has some informational edge, but this condition is not necessarily true. Some elements may not encourage productivity enhancement -for example, you use Sumitomo Bank as your main bank because your company is in the Sumitomo group. Insiders and outsiders are treated differently. The modern market system has merit by itself in many ways.

At the same time, I would like to emphasize that in any society non-market transactions play a significant role. For example, the mutual assistance system based on the Moslem ethic gives stability to the common people in the Indonesian economy. Granting the importance of market mechanisms, outside advisers as well as officials from the international organization should take a balanced view between market efficiency and traditional economic mechanisms.

A few words on the microeconomics of the recovery process: restructuring can be analyzed from different angles. Immediate write-offs make the accounting transparent, but also make the pain of financial setbacks more apparent. Using the principle of the cheapest cost avoider, auctioning of the troubled firm is the proper way for finding a management to run the enterprise in the best fashion. The conflict between shareholders and depositors (or lenders) is another interesting aspect. Government or Central Bank rescues always produce moral hazard problems. Next time, people think, government will help us. It is an undecided question whether compensation or an injection of capital to banks is a better way of minimizing the loss.

3. Consequences of pegging to the dollar

Financial crises are caused by the combination of various unfortunate factors, just as the derailment of a train is caused by concurrent factors. In this section, I will concentrate on one factor among many -that is, the misalignment of exchange rates. I will study the effect of pegging to the dollar, in a world where major currencies are in float on the emergence of financial crises. I will also explore the question how the pegging system can be improved and discuss the incentive structure that lies behind a country's choice of a certain exchange rate regime.

While dominant players in the world financial market, such as the United States and Japan, are under flexible exchange rates, smaller countries such as Thailand and Indonesia used to peg their currencies to the dollar, or virtually to the dollar. When adverse shocks hit Japan in the 1990s, Japan adopted an easy-money policy that depreciated the yen with respect to the dollar. In the short run, when wage–price rigidity prevailed, the Dornbusch type of overshooting of the exchange rate was ignited (Dornbusch, 1976). The jumps in the dollar exchange rate had a negative spillover effect -that is, a ‘beggar-thy-neighbour’ effect- on the other countries besides Japan. The United States was in a boom, however, so that it did not react with an expansionary monetary policy.

Naturally, as a result, developing countries in Asia experienced difficulties as the overshooting depreciation of the yen affected their economies directly. Their policy reactions to sustain the fixed exchange rate with the US dollar eventually failed. As soon as the danger of their failure was foreseen, their currencies were subject to severe speculative attacks. This is the scenario of financial crises from the perspective of exchange rate misalignment. As already mentioned, this may be a highly simplified picture that focuses only on one among many possible causes of crises, but I regard this explanation as important and worth examining. The nature of the process depends on the degree of flexibility of the economies, on the nature of macroeconomic interdependence and the incentive for a country to defect from the fixed or pegged system to the flexible exchange rate.

We use the familiar framework of Barro and Gordon (1983) with slight modifications. In each country, first the public proposes wages, and then the monetary authority conducts monetary policy. The monetary authority decides on monetary policy after knowing the wage level set by the public -or the price expectations formed by the public, in an alternative interpretation. As the alternative environment for this two-stage process, we have to distinguish the following features of the economy.

We consider a three-country economy with the price–wage inertia in each country. Country *A* and Country *B*, like Japan and the United States, are large countries, and they engage in a flexible exchange rate with respect to each other. Country *C*, like Thailand, is a relatively small country, and its currency, the Baht, is linked by the fixed exchange rate with the currency of *B*, the dollar. In this framework, we ask the following questions: (a) What happens to country *C* if country *A* is hit by an adverse supply shock and starts to devalue its currency with respect to *B*'s currency? (b) Does the floating of currency *C* help the economic situation of country *C*? And (c), does it help country *C* if it fixes its currency to a basket of currencies consisting of the currency of *A* and that of *B*?

The results are as follows. The peg to the dollar and the peg to the currency basket have a deterrent effect on wages through the credibility of the monetary authority's action under international reserve constraints. The float system does not have this merit, but instead is free of the loss arising from the discrepancy of monetary policy in *A* and *B* -say, Japan and the United States. The peg to a single country like Thailand suffers from this discrepancy through the policy stabilization effect as well as wage pressure that anticipates the devaluation of country *A*. The clean float is generally the best system under the assumptions of this model. According to its analysis, only when wage demand by labour unions is very strong can one make a clear case for the currency-basket peg.

A simple application of a monetary approach to the balance of payments indicates that this arrangement can create serious difficulties for the small country. Monetary or exchange rate coordination between the large countries may help the small country, but to only a limited extent. The complete float of the small-country currency and the currency-basket pegging are promising alternatives. Unless a complete float increases the degree of aggressiveness of the labour union, the complete float seems to be a better choice between these two alternatives.

In sum, the analysis in this section confirms the converse of Milton Friedman's dictum that if you trust your Central Bank, then you should adopt a flexible rate. If you do not trust your Central Bank or the social process of wage determination in your country, you may well adopt the fixed rate. The adoption of the fixed rate is justified if the exchange rate is pegged to the currency whose Central Bank has a stable monetary policy.

There is a serious danger in fixing to a single major currency when the exchange rate among major currencies is dramatically changing. Pegging to a currency basket resolves some of the difficulties provided that the average money supply of major countries is not superfluous. This is also a kind of 'centre vs. periphery' model. We still leave room for the analysis of competitive devaluation in this framework, and still need to compare our results with the analysis for the optimal choice of baskets for a standard macroeconomic model (Turnovsky, 1982).

In practical matters, one may wonder why the single-currency peg has worked well so far for Hong Kong. I have two answers. First, Hong Kong is open enough so that its economic structure is more classical than it would be with price-wage inertia. Second, even Hong Kong paid a high price by allowing a sharp stock market crash to occur in the autumn of 1997 in its process of defending the fixed exchange rate to the dollar. China is another example where the fixed exchange rate was held for a while. The fix is sustained by a strong capital control. I do not wish to finish this chapter by posing pessimistic questions, but what happens if Japan has to depreciate the

yen substantially again to ignite her economy? What happens to the Asian economy if China has to react to the yen depreciation by the yuan depreciation?

4. Diversity in national conditions and the need for a multiangled approach

According to my experience with Asian countries, in any country more or less universal economic principles are at work. The social, economic and political conditions that nations face are, however, extremely diverse from one place to another. Therefore the same policy recommendation may not work in the same way -even it were workable in principle, it cannot be implemented. We need a multiangled approach. The IMF approach is not the only effective means for recovery. The IMF approach is based on the neoclassical synthesis, or the combination of price theory and a simple monetary macro model. The price mechanism is used for intra-temporal resource allocation and the interest mechanism for inter-temporal allocation. What monetary policy should aim for is to stabilize the price level without distorting the price mechanism. Therefore the IMF does not wish to sacrifice the interest mechanism or free capital mobility and the autonomy of the monetary policy. Behind this theory may also be hidden, however, the motive of bankers and stock brokers of the western, industrialized world that they do not want to lose the Casino instruments that are based on the currencies and financial conditions of developing countries.

There is a well known trilemma in international finance -that fixed exchange rates, capital mobility and monetary autonomy cannot coexist. The IMF approach does not want to forgo capital mobility, certainly because of its belief in the market (interest) mechanism, and possibly because of the interest of gamblers in developed countries. This is a logical, orthodox approach, but the cost is a temporary loss of output and employment, as has been seen in South Korea, Thailand and Indonesia.

There are other approaches. As in Malaysia, or in Chile, the government can install capital control. The cost is certainly the weakening of the inter-temporal allocation power of the capital market, but the gain is the capability of domestic demand management. Malaysia has the political feasibility to impose capital control. The control is on the already invested foreign capital, so that it does not flow out. In Chile's case, new capital inflows were discouraged. After the financial shock, in Malaysia the adjustment process was serious and long. Chile's experience seems to be brighter, in terms of economic performance, though it suspended the practice quite recently. Since Chilean regulations were directed to reduce the surging supply of

inflows, in the face of recent stagnant supply the authorities reduced the reserve requirement to zero.

Instead of relying on a flexible rate, a country can adopt the fixed exchange rate. Hong Kong, like Argentina, has been keeping a fixed exchange rate by the currency board system -that is, by making the money supply determined by international reserves. This is drastically opposite to monetary autonomy. Hong Kong made it work because the Hong Kong economy is more or less a classical economy with flexible prices, and because it possessed a wealth of international reserves. The stock market crashed, however, in October 1997, which indicates that Hong Kong's currency board policy was not entirely free of cost. Argentina suffered significant drops in GDP in 1995 and 1999 and, in contrast to Hong Kong, Argentina had to rely on stand-by agreements with foreign creditors.

Depending on the circumstance, there is room for choice. The IMF's prescription -namely, to float the exchange rate- is only one of them. One should adopt a multifocused approach that takes account of the benefit and cost of a regime relative to the initial conditions in a particular country at a certain time.

Thus the adoption of fixed exchange rates pegged to the dollar is not generally a recommended prescription. The Asian financial crisis occurred not because currencies were in float but because currencies are artificially pegged and, in particular, pegged to the dollar. After the Asian crisis, Hong Kong, Malaysia and China continue to peg their currencies to the dollar. From the relativist stance of this chapter, their choices are to be respected. It is important to note, however, that these countries pay the cost of pegging. Hong Kong suffered severe asset market crashes, the fixed rates of China and Malaysia are supported by substantial capital control. For the flexible system to work, what is needed most essentially is the will of monetary authorities to conduct a stable monetary policy as well as the confidence of the public in that intention.

A fixed exchange rate seems to be out of question in this region at the present time. Certainly, the advantage of saving transaction costs and information costs can be significant in fixed exchange rates and, more concretely, in a unified currency system. The greatest obstacles against adopting such systems are that countries have to give up their monetary autonomy and that, when confidence in the fixed rate is shaken, a currency will be under severe speculative attack. Accordingly, the following preconditions are necessary for a fixed exchange rate or a unified currency among a set of countries.

First, the capital market as well as commodity markets should be *integrated* enough, and prices and wages should be *flexible* enough, so that the international

transmission of price levels can be conducted so as to realize the law of one price across the border. Then devaluation would no longer be an effective policy measure. Hong Kong at present is one example of such an economy.

Second, the countries participating in a fixed exchange rate union should have a sufficient amount of *reserves*. This is a difficult condition for many Asian countries right now.

Third, the peg should start from a *market-basket peg* rather than a single-currency peg like the dollar peg. In this scenario, Asian countries peg first to the market basket of the dollar, the yen, the yuan and so forth. If this is supported by the intensive integration of goods and financial markets, then it may lead to a single currency. (If Asian countries were to follow the European scheme, they would make a composite ecu equivalent of Asian currencies. I do not think that this will work given that the share of US trade is very high in most countries.)

Right now, Asian monetary authorities do not fully recognize either the danger of pegging solely to the dollar or holding their international reserves in a dollar-dominated portfolio. Nor do private economic agents fully recognize the implicit benefit of invoicing in other currencies such as the yen.

In the domestic scene, Japan's tax authorities still keep such measures as the withholding tax on issues of yen-based short-term bonds by the pretext of deterring tax evasion. It is at least partly the Japanese government that prevents the internationalization of the yen. Suppose it is a good thing for Japan to internationalize its yen, because of the convenience in international transactions and because of the possible seigniorage gains. Then it is time for Japan to signal explicitly that it is serious in lifting all the restrictions on the short-term market in order to make the yen a truly international currency. And it is for Japan to send politicians and entrepreneurs to persuade Asian countries about the direction of a currency area that is not solely but is significantly based on the yen.

5. Japan's current diplomacy towards international financial architecture ¹

I will end this chapter by briefly reviewing Japan's attitude toward building an ideal international monetary system. This is an appropriate place to do so because the Miyazawa Initiatives virtually gave birth to the expression 'International Financial Architecture'.

¹ I am indebted to Ko Nakayama, a graduate student at Yale, for extensive discussions and research assistance for this section. Errors and opinions are strictly my own.

a) *An Asian Monetary Fund and the Miyazawa Initiatives*

During the Tokyo Meeting of Ministers in their effort to rescue the crisis situation of Thailand in August 1997, many Asian countries were interested in the idea of a permanent international facility that provides financial support to troubled countries.² As a host country of the Minister Meeting, Japan made a significant commitment to the Thai economy. In late September 1997, after the Finance Ministers' Meeting in Bangkok, Japan launched a plan for the Asian Monetary Fund (AMF) in the annual World Bank–IMF meeting held in Hong Kong. The plan for the AMF has in basically the following components: (i) The IMF surveillance mechanism will be supplemented by local surveillance by the AMF in the region, and (ii) in accordance with the IMF economic adjustment programme, participants of the AMF will engage in financial support of the troubled countries in the region.

The US Treasury as well as high officials in the IMF expressed strong antagonism against Japan's proposal. Stanley Fischer, Senior Vice President of the IMF, said that the Asia Fund could undermine the authority and effectiveness of the IMF itself.

The criticisms of the AMF plan often referred to such factors as the duplication of public goods supply (an overlap in the functions of AMF and IMF), the difficulty in keeping the same standard in conditionality and the increased danger of moral hazard. Perhaps affected by these criticisms, the word 'AMF' retreated a little from the scene. The basic ideas still persisted and were re-bundled as 'The Manila Framework'. In this framework, the presence of the new Fund was in the background, with objectives, (i) and (ii).

Then, on 3 October 1998, Kiichi Miyazawa, Finance (formerly Prime) Minister of Japan announced the new plan, the New Miyazawa Initiative, at the meeting of Asian Finance Ministers and Central Bankers (Indonesia, Malaysia, the Philippines, South Korea and Thailand). The Initiative is motivated by the need for Japan to strengthen ties with Asian countries. Sacrificing the tight budget conditions facing Japan that is also under severe recession, Japan declared that it would be ready to contribute US\$ 30 billion. \$15 billion will be used to assist the mid-term and long-term development and the other half will be used for the short-term capital needed during the process of implementing economic reforms. The Japan Export–Import (Jex-Im) Bank will be an instrument to process the support.

According to the Japanese government, the New Miyazawa Initiative consists of mainly bilateral support for a country that suffers from a financial crisis. The initiative is supposed to rescue the country and to contribute to the stability of international financial markets. This feature is in contrast to the

² In ASEAN countries, it is said, similar plans had been discussed before.

AMF, whose main purpose was to stabilize the currency. This programme immediately attracted attention. In fact, the Japanese government and other countries such as Thailand, Malaysia and Indonesia came to mutual agreements to implement the New Miyazawa Initiative.

b) Motivations for the AMF and the limitation of the IMF

The motivation for building the AMF can be traced to the lessons of Asian crises that were triggered by the Thai crisis. They taught us, at least, three lessons: (i) Both appropriate foreign exchange system and proper conduct of macroeconomic policy are crucially important for a sound financial mechanism. (ii) In order to manage and cope with fragility in the existing financial institutions in Asian countries, it is important to keep a sound monetary policy. And (iii) particularly in case of newly industrialized countries, a currency crisis in one country was proved to spread easily to others.

The rationale for the AMF can be found in the following two examples: First, it is important for Asian countries to exchange precise economic observations and frank opinions on their economies in order to prevent monetary crises by cooperation. Second, if a monetary crisis takes place, the amount of IMF support may be insufficient. In that case the AMF can provide a sufficient supplement. The Japanese government insists that the AMF neither trespasses on the genuine functional area of the IMF nor triggers additional moral hazard problems.

Here let us examine, before discussing the incentive structure even further, the present functioning of the IMF. The following is my impression of the IMF operations in financially troubled countries, as I found out as one of the evaluators of the Enhanced Structural Adjustment Facility (ESAF), a concessional loan programme to low-income countries including several sub-Saharan countries.

The transmission of IMF policies to recipient countries can be described as follows. The IMF is a top-down, hierarchical organization. The guideline for policy agreement, the Policy Framework Paper (PFP), is often drafted almost totally in Washington, to be filled in with actual numbers only when it reaches the recipient country. Like a caravan whirling sand in its wake, the IMF mission stays just for a few weeks, collects (sometimes makes up!) data, negotiates the programme and fills in the PFP. I sympathize with mission members who have to work out programmes, torn between Washington's plan and the appeals of the recipient government.

The IMF mission group is dispatched to a recipient country with guidelines based on the 'Washington Consensus' -policy prescriptions based on free-market principles and monetary discipline. The current influential

generation in the Fund was educated at the peak of the orthodox price theory's popularity and when a monetary approach to the balance of payments was in vogue. Those theories are sound in many cases, but we now know that they should be supplemented with new developments in economics such as an explicit account of inter-temporal choice, and economics of incomplete information that can deal with reputation, commitment and default. New developments are studied in the Research Department but do not seem to be sufficiently utilized in field operations.

Consequently, a uniform menu following the 'Washington Consensus' is applied to many countries. During the Asian crisis, we observed that, regardless of the existing macroeconomic conditions, such as budget deficits or the balance of payments deficits, the same austere prescriptions were applied: the IMF might have closed too many banks in Indonesia. The adjustment process for individual countries was not taken into account. The manure scene in Africa is an illustration of the disregard of the adjustment process.

Throughout the IMF, multiple layers of monitoring networks exist. The executive committee is supposed to monitor the Secretariat of the IMF. Among executive committee members major countries, guided by their individual national interest in helping lenders of the same nationality, attempt to influence the IMF decision through the Board of Directors' Meetings and other informal channels of influence. The IMF and the World Bank are traditionally dominated by Americans and Europeans. Once this influence is in place at the executive level, the next channel is for those high-ranking members to motivate staff members at the next level. The bureaucratic process can be readily studied at the IMF.

Let us discuss the pros and cons of creating an additional monetary institution in Asia in the light of the incentive theory. Visualize the situation where each member of an international financial organization (IFI) offers an incentive schedule depending on what the institution does. The IFI is a principal that delivers activities so long as its reservation utility level is satisfied. Naturally, a member country would like to attach a stronger incentive to the activity of the IFI that generates a high benefit to the country (see Hamada, 1998).

On the other hand, if the achievement of independent goals is not counted as a part of reservation utility, either because it is non-pecuniary or because it is not as easily captured concretely as other benefits, then members will have to work harder to counter agents' objectives. In order to give the institution the right incentive, members have to take into account the institution's preference, such as deflationary bias, and subtract it from the benefit that members obtain from a service. Member countries recover less overall rent from the institution owing to the disappearance of benefits through this

non-member-oriented, independent objectives of the international institution. If the IMF is too conservative and restrains certain activities and services, then member countries have to increase the incentives for the restrained activity in order to counterbalance the IMF's own incentives.

Our basic questions are: Are member countries benefited by the existence of more kinds of IFIs? What happens if they have different own objectives from each other?

According to our analytical results, in the absence of externalities with respect to production and consumption of services between the two IFIs, the existence of an additional IFI normally gives better benefit because the feasibility sets for the pertinent countries will expand.

If they have different own incentives from the institution, then member countries may choose the institution that has a closer fit to their individual preferences. In the case when the satisfaction of the institution's own objective is not counted as a part of reservation utility, this situation will very likely emerge. In concrete terms, the above argument means the following: If the IMF and the World Bank have different objectives, what happens? Usually, in the absence of externalities, the existence of two institutions are beneficial because member countries can have more choices. In theory, if not in practice, a country could be an active member of the IMF but not that of the World Bank, and vice versa. When their services are mutually interacting and have externalities, however, some difficulties emerge. If they produce the *same* public good, then one of the institutions could possibly be redundant with respect to that service. If they have externalities with respect to cost, the production of one element will congest the production of the other IFI, and this also creates a non-optimality problem. In that case, institutions should be merged, because the duplication of the supply of public goods is undesirable.

On the other hand, if the major role of the IMF and the AMF is to provide loans to troubled countries such as rescuing crisis countries and accordingly has more private good features, then the coexistence of two institutions may be beneficial to the world. Particularly when Japan cannot represent its wishes in proportion to its financial contributions to the IMF and the IBRD, while the United States does not fully cooperate with the IMF with respect to payments of its subscription, Japan's intention to establish another fund can be fully understood.

The general problem of Japanese financial diplomacy is that it is seldom articulate. When a government wishes to initiate a new plan, in particular, a plan using a large amount of expenditure such as US\$ 30 billion, it will most likely discuss its implications in such a way as to maximize its impact on world public opinion. Many countries would add some philosophical undertone. When the AMF proposal was made, the idea was just explained in

the Ministers' meetings in Bangkok or in Hong Kong. There was no official or unofficial publication that justified the proposal, described the process of implementation, analyzed the economic functions, let alone the philosophy underlying the proposal. There was no systematic account of why the activity of the IMF was insufficient, why Asia required an additional regional monetary institution, why the building of the AMF did not interfere with the normal function of the IMF, and finally why the AMF was necessary for solving the Asian currency crisis.

Miyazawa is, though, one of the most brilliant and articulate politicians. Allegedly, he likes the top-down style of governance rather than the consensus-building style. (He is one of the most cosmopolitan ministers, from whom we may expect a most articulate expression and initiative.) I am afraid to say, however, we are a little disappointed by the way both the AMF and the New Miyazawa Initiatives were communicated to the world community by the news media.

Let us start with the disappointment. Naturally, in most countries, politicians were looking forward to receiving financial help through the Miyazawa Initiatives. However, the Miyazawa Initiatives did not constitute any formal systematic statement of the purpose, logic, and the mechanism of the plan. They just stated how much money went through different channels, and so forth. This defect is caused by the jurisdictional division of governance and administration within the Japanese cabinet: if the Miyazawa Initiatives' money goes through foreign affairs, then it takes this form. If it goes through the Ministry of Finance, then it takes that form; and if it goes through the other channels, then it takes a different form. All of this is very dampening on the effect of policies. Suppose the same amount of money -or less- is spent by an American initiative -by a Baker Initiative, or by an Albright Initiative- they will embellish by grandiose statements why the United States is spending such an amount of money to save the health of Asian countries. Japan's international communications sound like a bureaucrat's résumé prepared for the various council meetings in the government. In those meetings, they do not repeat the total logic of the issues, they just state the items to be discussed in the advisory council. If these bureaucrats present and explain the items in the meeting, then the discussion will go well. The memo is good if it is explained, but a memo by itself is not enough for Japan to publicize its opinions, and the Japanese government should allow spokesmen, vice-ministers of finance or ministers to express his or her (never her) opinions in systematic and individual vivid ways to impress the world. The lack of this kind of entrepreneurship is one of the reasons that the AMF may not work as well as it should. But by the establishment of the AMF and other institutions where Japanese can participate freely, Japanese financial bureaucrats may learn to be more articulate.

Using Japan as an example, let me illustrate the processes of monitoring and influence. In terms of human capital, Japan's involvement in the IMF is tenuous. Generally, Japan kept a low profile in world politics after the Second World War. At the beginning of 1992 the Japanese occupied 30 positions among the 1700 employees in the IMF. The percentage share is notably lower than the relative contribution of Japan (around 7%). At the World Bank, the ratio of Japanese professionals to the total employee population is even smaller -about 1%.

Moreover, the majority of Japanese employees at the World Bank and the IMF are on leave from the government, Central Bank and related institutions in Japan. Some of them are working in a transitional or stopgap position in Washington while waiting for the next important position at home. Aside from the relative ratio of employees, Japan's position in these international institutions is generally not conspicuous.

There are at least three reasons for the Japan's low profile in international institutions. The first is her reaction to the Second World War; Japan, like Germany, maintained a passive attitude in international politics after the war. Subsequently, Japan has acted as a 'generous uncle' in the world community.

The second reason for Japan's low representation in the IMF is her lack of international leadership and entrepreneurship. Japanese education over-emphasizes memorizing and calculation. Students are taught to conform to conventional ideas and not to express their independent, creative ideas. I have taught both Tokyo University students and Yale students. Students at both universities are well trained intellectually. The critical difference between them is that Yale students feel free to voice their independent opinions. It is hard for Japanese young employees in international organizations to cope with the culture of debate and persuasion.

The third reason for a low profile is owing to the difficulty Japan has in taking the initiative in international action. Japan's quota in the IMF is always limited in such a way to protect the European and the American dominance. This is despite the fact that Japan has provided additional funds to the IMF to finance various rescue operations for troubled countries. Difficulty in taking initiatives, coupled with lack of human capital and with latecomer disadvantage, necessitates that Japan take the easier position of being passive. An alternative way for Japan was to build its 'own' international organization which, as already said, was strongly opposed by the United States and the IMF.

The 'downside' to establishing another institution, say the Asia Fund, includes the following: (i) since international monetary stability and the credibility in the exchange market are public goods, it is more economical and less confusing to produce them via a single institution; (ii) since the IMF itself

creates moral hazards and related easy attitudes in borrowing countries, two or more institutions will aggravate this tendency; and (iii) Japan lacks financial entrepreneurship, as exemplified by the recent financial turmoil. Accordingly, the Asia Fund may not be able to contribute much to the world or Asian welfare, and could become the vehicle by which Japanese officials are provided with '*amakudari*' (golden parachutes).

To respond to (iii) is difficult, but as to (i), one can argue that a substantial part of the IMF's activity is not the supply of public goods. Concessional lending like the ESAF as well as the relief finance to financially troubled Asian and CIS countries has the nature of private goods. Therefore, (i) is only partially right. As for (ii), if the present situation creates excessive moral hazards, that is the problem of the present IMF itself, as well. Ideally, a competitive second fund may work to mitigate the degree of moral hazard. If the world needs a supply of additional loans, even the extension of loans with the same degree of moral hazard may be desirable.

If certain countries have a dominant influence in an institution, or if they have biased motives to steer the institution, an outsider country has every reason to seek the option to build another one. Competition in institution-building is one source of innovation. Therefore, the Asia Fund plan should be studied with careful theoretical and empirical analysis. It should not be dismissed simply because of opposition from the American or other governments in an effort to protect their own interests. When we discuss the necessity of AMF, we must try our best to distinguish between opinions based on economic logic and those that are driven by emotion and sentiment. Is it just mere speculation to judge that Washington opposes the AMF because it is reluctant to see the emergence of a regional economic bloc under the leadership of Japan? Earlier in this century, Japan engaged in an imperialistic expansion into many Asian countries under the name of '*Dai-Towa-Kyoeiken*' (Co-prosperity Sphere for Greater Asia). Some Asian countries are still haunted by that nightmare. Gradually, they must begin to take a forward-looking attitude about the potential benefits from mutual cooperation rather than being reminded by the past.

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13. THE IMPACT OF FINANCIAL GLOBALIZATION ON TRANSITION ECONOMIES

Bernard Snoy *

1. Introduction

By allowing us to be taken in the world of international finance, we, Russians, who are so fragile, have been lead into financial crises, which do not concern us and which we could have avoided.

(Alexander Solzhenitsyn, *Russia in Collapse*, 1998)

‘As regards capital movements, the preconditions for a successful opening of national markets must be carefully ascertained and created. It is essential to prevent participation in global capital markets from becoming a channel or a source of domestic financial instability, with the attendant risk of negative spillovers onto the rest of the world economy. The opening of the capital account must be carried out in an orderly, gradual and well sequenced

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manner, keeping its pace in line with the strengthening of countries' ability to sustain its consequences. The Committee underscored the crucial importance in this regard of solid domestic financial systems and of an effective prudential framework' (Communiqué of the Interim Committee of the Board of Governors of the IMF, 4 October 1998).

Although Alexander Solzhenitsyn is not an economist and could not have read the communiqué of the Interim Committee, his intuition leads us to raise a question which economists cannot ignore: to what extent does globalization of financial markets help the former communist countries to achieve their objective of transition to a market economy or does the integration of still fragile economies and societies in the world of international finance actually risk dragging them into financial crises with heavy economic and social costs, which could actually lead to delay or regression in the transition process?

Financial globalization -i.e. integration in international capital markets- involves obviously both benefits and risk to the countries in transition.

Potential benefits are both of a macroeconomic and structural nature:

- As for other developing economies, capital flows into the transition countries can make a significant contribution to growth. In most transition economies, domestic savings are low and financing costs high owing to underdeveloped financial systems. While the physical and human capital stock in these countries is generally abundant by the standards of comparable mostly middle-income countries, it is inefficiently employed and partially obsolete. The potential productivity (and profitability) of new capital is therefore likely to be higher than in more settled market environments. Investment for restructuring, combined with improved management and advanced technology, offers opportunities for raising the yield of some of the existing capital at relatively low cost. Foreign capital can help to realize this potential, but governments must unlock it by creating a strong investment climate.
- The most important benefits, however, are of a structural nature, in the contribution that foreign capital can make to the specific transition process, which involves market liberalization, privatization, raising the intensity of competition, tightening financial discipline, setting standards and more generally establishing the legal, institutional and human bases of a market economy. But again to unlock this potential, governments must create a favourable investment climate.

On the other hand, the risks of exposure to the volatile international environment created by financial globalization have been made quite obvious by the recent Russian financial crisis. The risks are highest in countries that have integrated themselves into the international capital markets but have so far failed to establish the foundations for macroeconomic and financial stability, and more generally the broader institutional foundations for a well

functioning market economy. The main lesson to be learned is that building such foundations takes time, particularly in the less advanced transition countries.

Short-cutting the transition by liberalizing capital flows ahead of the establishment of an appropriate regulatory and institutional framework carries considerable risks. Governments should therefore explore market-based means of constraining the volatility of short-term capital flows as long as significant components of the transition reforms have not yet been implemented.

2. The volume and composition of capital flows ¹

a) The socialist economies as borrowers – capital flows pre-transition

Irrespective of ideological misgivings, the central planners were no strangers to the international capital markets. Since the late 1970s, the USSR, Poland, Yugoslavia and Hungary, and later Bulgaria, approached the syndicated loan market, generally through their foreign trade banks, and expanded the use of export credit and short-term trade finance.² Equity finance was obviously foreign to socialism, and the decentralized nature of bond finance was not in favour with planners. The sovereign risk of these economies was well regarded, as evidenced by their ability to rapidly raise their levels of indebtedness -although Poland underwent a series of debt restructurings from as early as 1981.

b) From official finance to private investments – capital flows in the transition

The transition process radically changed both the volume and composition of capital flows. From 1989 to 1993, they were shaped by western governments' determination to make the transition 'stick', coupled with a wait-and-see approach by private sources of funds. Country and commercial risk was, and was perceived to be, extremely high. When economic performance improved and the transition progressed, private capital began to enter the market, first timidly, then with great speed.

Reflecting these developments, capital flows into the region have followed a distinct sequence, with official funding, FDI, non-guaranteed bank loans, dedicated equity funds and finally international bond issues and direct local stock and money market investments entering successively at one–two-year intervals (see Table 13.1).

¹ This section summarizes section 4.1 of EBRD (1998).

² Forfeiting developed into an art in COMECON trade finance, perhaps more so than in any other part of the world.

Table 13.1
NET CAPITAL FLOWS TO CENTRAL AND EASTERN EUROPE AND RUSSIA, 1976-97^a
(millions of US dollars)

	Annual average			1989	1990	1991	1992	1993	1994	1995	1996	1997 (revised)
	1976-80	1981-85	1986-90									
Total flows	1,179	1,805	4,871	4,032	3,396	14,464	24,874	23,832	16,035	33,399	40,704	61,122
Private flows	862	973	3,935	2,866	-8,355	-6,409	6,213	14,272	12,214	28,427	33,079	51,033
Direct equity investment	15	18	122	187	431	2,143	3,657	5,157	4,548	12,282	9,242	14,494
Portfolio equity investment	0	0	30	271	140	321	339	856	1,131	2,271	2,170	3,371
Commercial banks	694	680	76	908	-15,089	-8,226	996	1,412	1,976	8,412	11,102	7,800
Other private creditors	153	275	3,707	1,500	6,163	-647	1,221	6,847	4,559	5,148	10,565	25,368
Official flows	317	831	936	1,166	11,751	20,873	18,661	9,580	3,821	4,872	7,625	10,089
Internat. financial institutions	204	625	-126	-1,143	1,112	5,729	3,807	3,124	3,001	3,459	3,756	4,257
Bilateral creditors	113	206	1,062	2,309	10,649	15,144	15,054	6,435	820	1,514	3,869	5,832

Source: Institute for International Finance.

^a Data cover Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.

Beginning in 1989–90, official funding increased sharply, while private sources of funds were largely absent from the region. Net official flows peaked in 1991 at US\$ 21 billion. After 1993, they declined both as a share of the total and in absolute terms.

Private flows began to exceed net official flows in 1993, and by 1997 accounted for 84% of total net capital flows (excluding net resident lending abroad) into the seven recipient countries covered by Table 13.1.³ This represented over 5% of the region's GDP and 22% of aggregate net private flows into the emerging markets.⁴ The transition economies were among the few emerging market regions where flows increased strongly during 1997. Developments during the first half of 1998 showed continued strong inflows. However, this trend has been reversed following the Russian crisis and inflows for 1998 as a whole fell substantially below the 1997 level.

After a relatively minor presence in earlier years, private flows of all types have, since 1996 and especially in 1997, been increasingly destined towards Russia. Despite a slowdown after the onset of the Asian crises, Russia was still estimated to account for more than one-third of all private flows into the region in the first six months of 1998. While foreigners have invested in Russia, however, Russians have increasingly transferred funds abroad or engaged in internal capital flight. These transfers would appear to have been of similar magnitude to that of net foreign capital inflows into Russia during 1996 and 1997. The main channels have been the non-repatriation of export proceeds and currency purchases by the population.⁵

3. Foreign direct investment ⁶

a) *Continued rise and increasing diversification of FDI* ⁷

FDI into the region in both 1997 and 1998 far surpassed previous levels at respectively US\$ 14 billion, (accounting for roughly 14% of FDI outside the developed market economies) and US \$21 billion. The destination of FDI flows has clearly been diversifying in recent years. Most FDI is still concentrated in a few countries, but whereas Hungary and the Czech Republic were lead destinations in earlier years, Poland dominates at present among the EU accession countries and Russia received \$3.7 billion in 1997. Still, flows into Hungary have continued at a strong pace, and a

3 Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, and the Slovak Republic.

4 Total flows as reported by the Institute for International Finance, May 1998.

5 Communication by the IMF. Typical Russian media estimates of dollar holdings by the Russian population range between US\$ 30–40 billion.

6 This section summarizes section 4.2 of EBRD (1998).

7 See European Union (1997) and UNCTAD (1998).

number of countries in 1997 (e.g. Azerbaijan, Bulgaria and Romania) or even under the more adverse conditions of 1998 (Croatia, Estonia, Lithuania, the Slovak Republic, Albania, Georgia and Moldova) recorded significant increases.

Across the region, privatization policies have been a significant determinant of trends and fluctuations in FDI flows. For instance, the early start of the Hungarian cash-based privatization programme largely explains the significant FDI inflows shortly after the onset of the transition. In the period 1993–95, privatization proceeds in Hungary accounted for 85% of FDI inflows. In the latter year, FDI inflows into the Czech Republic also experienced a significant increase, driven by the privatization of SPT Telecom and a large oil refinery (jointly accounting for 60% of inflows in 1995). Despite the privatization-related increase in FDI in Russia during 1997, foreign investment in the region's largest country remains modest. For example, at end-1997 the total FDI stock in Russia was only half of the sum invested in Hungary between 1989 and 1997.

b) Progress in transition matters for FDI

FDI exploits long-term economic opportunities in the recipient countries. The economic potential of the region continues to be great, but countries have differed in their willingness and ability to unlock this potential through structural reforms. This is reflected in the regional distribution of FDI. Leaving out the three oil and gas economies in Central Asia (Azerbaijan, Kazakhstan and Turkmenistan), the rank correlation coefficient for 22 countries between the EBRD's average transition indicator in 1997 and cumulative FDI *per capita* for 1989–97 is 0.89. This association supports the conclusion that it is the reform process which opens opportunities for profitable investment and which, through its impact on risk, motivates investors to take advantage of them.

c) FDI matters for enterprise restructuring

FDI contributes to the transition and economic performance across the region in three major ways. First, FDI may directly increase capital accumulation.⁸ Second, it raises the productivity of the firms and benefits export performance.⁹ Third, it generates technological and organizational

8 Even in the context of acquisition investments, capital accumulation tends to take place as part of modernization and restructuring strategies. In an empirical study covering 69 developing countries Borensztein, de Gregorio and Lee (1995) find that the inflow of FDI does not crowd out but may instead stimulate domestic investment.

9 For an overview of case studies and enterprise-level data on restructuring in foreign owned enterprises, see Szanyi (1997).

spillovers for domestic suppliers and competitors.¹⁰ More generally, in the context of transition, FDI tends to have a 'package' of attributes that can contribute to forming market-oriented institutions and behaviours. It does so through upstream and downstream linkages and demonstration effects (see Matouschek and Venables, 1998a; 1998b).

4. Commercial bank lending, international bond finance and portfolio investments¹¹

a) Catching up with the transition – non-FDI private capital flows

In addition to FDI, other types of capital flows into the transition economies have expanded rapidly in recent years, after first emerging in 1993. These include commercial bank lending, international bond issues by governments and corporations from the region and portfolio investment into the regional equity and money markets. The share of private sector counterparties in non-FDI transactions has continuously increased, and experienced a surge during 1997 and the first half of 1998– as if to catch up with progress in transition. While private equity issues have remained restricted to the most advanced transition economies, portfolio flows into the government securities markets have characterized a number of countries at less advanced stages in transition.

For both commercial bank lending and international bond issues, there was a gradual increase in flows over several years followed by a sharp acceleration in 1997. International equity issues picked up somewhat later and experienced a similar surge in 1997.

Portfolio investments in the local stock and money markets experienced a rapid expansion starting around 1995. While portfolio flows were initially significant only in the Czech Republic (mainly in equities) and in Hungary (in government securities), in 1996 and 1997 Romania and Russia started to attract significant portfolio inflows into their government securities markets. While statistics on portfolio flows into local money markets are not systematically collected, estimates suggest that during 1996 and 1997, foreign investment in short-term domestic government securities may have represented more than one quarter of net private capital flows into the transition economies (Table 13.1).¹² The lion's share of these investments were made in Russia, where the stock of foreign-held T-bills has been estimated at US\$ 17 billion (face value). More generally, it is the less advanced countries in

10 See Hunya (1997) and Mayhew and Orłowski (1998). For instance, the correlation between the stock of FDI and the growth in labour productivity since 1989 across all transition economies is 0.7 and highly significant.

11 This section summarizes and updates section 4.3 of EBRD (1998).

transition which have relied particularly strongly on portfolio investment inflows. Most of the portfolio investment in short-term government debt markets has quit the region since mid-August 1998, leaving these countries particularly affected.

b) *Impact of the emerging markets' crisis*

The impact of the emerging markets' crisis on non-FDI capital flows has been more pronounced than on FDI.¹³ Total syndicated lending to the region declined by more than half from US\$ 27.1 billion in 1997 to US\$ 12.5 billion in 1998. This drop, apparent since early 1998, reflects the increased caution among commercial banks towards emerging markets in general, following large losses in Asia. Russia alone accounted for US\$ 10 billion of the decline in syndicated lending, but syndicated lending also declined sharply in the Czech Republic, Poland, the Slovak Republic, Croatia and Romania.

The impact of the Russian crisis on international bond issues from the region was immediate and stark. There were no international bond issues at all in September and October and monthly issues in November and December were US\$ 0.5 billion and US\$ 1.4 billion respectively, down from a monthly average of US\$ 2 billion in January–July 1998. Total equity issues from the region have also fallen sharply from US\$ 9.4 billion in 1997 to US\$ 5.5 billion in 1998.

Just as significant market differentiation appeared in the volume of international capital flows, similar variation emerged in key asset prices -in yields on international bonds and domestic money market instruments, and in share prices. For example, spreads on Ukrainian eurobonds rose in late September to over 12 000 basis points, decreasing to around 6000 basis points by the end of the year. Other countries where spreads on international bonds increased significantly were Kazakhstan, Romania and Russia, although the spreads have since come down in Kazakhstan. In contrast, spreads on the eurobonds of countries such as Hungary, Slovenia and Poland edged up much less and indeed have not moved at all in the wake of the Brazilian devaluation in 1999, confirming their relative resilience against shocks in other emerging markets.

12 Aggregate net portfolio inflows reported by the IFS into the seven major recipients equalled US\$ 21.1 billion in 1997. Subtracting the US\$ 3.4 billion in aggregate portfolio equity flows in Table 13.1 yields an estimate for non-equity portfolio inflows of US\$ 17.7 billion. Alternatively, the item 'Other private creditors' (which captures residuals) in Table 13.1 may be adjusted by subtracting net flows on bonds, yielding estimates of portfolio investments into government debt markets plus trade credits (another residual) of US\$ 9 billion in 1996 and US\$ 16 billion in 1997.

13 Figures reported below on syndicated lending, bond and equity issues from the region come from *Euromoney's* Loanware and Bondware databases.

Share prices dipped sharply in the two months after 17 August across the whole region. However, in the most advanced transition economies -the Czech Republic, Hungary, Poland, Slovenia and, to a lesser extent, Croatia-stock markets have since recovered to about 70% of the value prevailing at the beginning of 1998. In Hungary and Poland this followed some reallocation of portfolio flows away from other emerging markets to the 'safe havens' of central Europe. In contrast, the stock markets of the Baltic states, Romania, Russia, the Slovak Republic and Ukraine all collapsed by more than half after August 1998, and remained far more volatile in the early months of 1999.

c) *Building long-term relationships or exploiting short-term gains – capital flows in the transition*

Commercial bank lending can usefully complement FDI in providing access to trade and project finance, transferring financial technologies and exposing private counterparties to financial discipline. International bond issues from the region have presented a means of raising revenues for governments in the context of underdeveloped domestic securities markets, and often at more favourable terms. International equity issues have exposed corporate counterparties across the region to international disclosure and accounting standards and thereby have contributed to improving corporate governance. However, the dramatic shift in investor preferences against those emerging markets that had recently benefited most from increasing access to the international capital market has highlighted the vulnerability of particularly less advanced transition economies to the volatility of short-term capital flows in particular.

Commercial banks were the main source of external funds for eastern Europe and the USSR during the 1980s. During that period, close working relationships were built with foreign trade banks. These relationships survived the uncertainty and debt defaults of the early transition years, though the volume and nature of lending changed progressively. Export finance opened the way to project finance and collateral requirements were gradually replaced by uncovered forms of documentary credit and medium-term refinancing facilities.

When commercial bank lending expanded first slowly in 1992–94 and more rapidly in 1995–97, it was mostly on the basis of these relationships.¹⁴ The sharp increase in competition from other sources of capital inflows during this period led to a very rapid fall in spreads, possibly beyond what was justified by underlying risk. Spreads on foreign borrowing have consequently been adjusted sharply upwards since the Russian crisis. Nonetheless, the

¹⁴ For the CIS, bank-to-bank lending has been much slower to develop, in part because most existing relationships of western banks were with Russia's Vneshekonombank.

demand for commercial bank lending is likely to remain strong over the medium-term and, following a likely reduction over the near future, lending to public and private sector counterparties should recover.

Apart perhaps from some of the equity funds that have long been operating in the region, the supply of portfolio flows and bond finance have, by their nature, relied far less on direct relationships built over time. As in other markets they are motivated in part by the well established benefits of portfolio diversification. However, their rapid growth during 1996–97 was driven by a combination of macroeconomic tensions in the recipient countries, the ‘discovery’ of the region by international investors and a period of high liquidity on international capital markets.

Tensions within the macroeconomic policy mix of several countries, including Poland in 1995 and the Czech and Slovak Republics and Russia in 1996–97 have been a major reason for the attraction of short-term portfolio flows. Significant uncovered interest differentials emerged as the result of tight monetary policies and pegged exchange rates, combined with a loose fiscal stance. In Russia, for instance, returns on investments in government securities in mid-1997 averaged 50% in foreign currency terms. Even higher returns were offered in some other CIS economies. Despite high real domestic interest rates in most cases, foreigners were offered a significant premium for holding regional government securities, the size of which varied with underlying macroeconomic risks.

The region does not have a history of credit ratings, and first formal ratings came, for most countries outside central Europe, at a time when reform had already progressed. This put these countries ‘on the map’. In 1996–97, first credit assignments by Moody’s and/or Standard & Poor’s were given to Russia, Romania, Kazakhstan, Latvia, Lithuania, Moldova, Bulgaria, Croatia and the cities of Moscow, St Petersburg and Nizhny Novgorod. Partly as a result, international fund managers ‘discovered’ the region, and it is interesting to note how the most aggressive funds moved from one security to the next successively in search of new arbitrage margins (such as from Russia to Ukraine and Bulgaria, or from Russian federal T-bills to regional ones).¹⁵ In the case of Russia in particular, moral hazard associated with the notion that Russia was simply too big to fail probably also played a role.

The risks of relying on volatile short-term capital flows were known prior to events in Asia and Russia. The growth of the investor base beyond the informed risk-taker is a relatively recent phenomenon, however. The

15 A BNP brochure refers explicitly to the Russian GKO as being ‘close to their sell-by date’. It goes on to state that ‘by shopping around, you can equip yourself with the necessary breathing apparatus to keep climbing from here’ (BNP, Eastern European Investment Banking Group, August 1997).

post-crisis volatility in even fundamentally sound financial markets reinforces the conclusion that information lags and herding may have significantly contributed to the surge in capital flows to the region. The amplifying impact that herding may have on the volatility of short-term capital flows has recently revitalized the debate about appropriate policy measures to protect oneself from such volatility.

5. Maintaining access, containing volatility – some policy options¹⁶

Maintaining access to the international capital markets will be crucial for the transition economies, if they are to finance external imbalances induced by the transition and to benefit from technological and organizational spillovers associated with foreign investments. The most important lesson from the Russian crisis and from previous financial crises in emerging markets is that prudent macroeconomic management supported by vigorous structural reforms is the basis for a healthy integration into the international capital markets. The risks of volatility are highest in countries where the underlying fundamentals are weak. While all transition economies will be temporarily affected by the tightening of international liquidity, long-term rates of return across the region remain high. Unlocking this potential requires the creation of an investment climate favourable to FDI and other long-term flows.

At the same time, capital inflows in the context of incomplete structural reforms carry considerable risks and may indeed magnify underlying macroeconomic and structural weaknesses. First, capital inflows may themselves be a cause of rising external imbalances. If these inflows are used to cover excessive public borrowing or a rapid increase in consumption, rather than laying the basis for productivity improvements and future export earnings they may exacerbate the underlying imbalances and eventually precipitate a loss of investor confidence. Second, the financial institutions and markets that intermediate part of these funds are still highly immature in many countries in transition. This heightens the risk of bank failures and associated dangers of volatility in capital flows.

A well functioning banking system is thus essential to contain the risks of instability and a key factor of an investment climate that attracts long-term foreign investors. A related conclusion is the need to develop local sources of long-term finance. Pension reform, when combined with funded pillars and determined financial sector reform, could be an important source of such finance.

¹⁶ This section reproduces key elements from section 4.4 of EBRD (1998).

a) *Prudent macroeconomic management*

A sound macroeconomic policy framework is a central component of a strong investment climate. It includes responsible fiscal, monetary and exchange rate management. Public sector solvency is a crucial factor in maintaining the confidence of investors, especially in countries where policy credibility is not yet well established. In addition to solvency, sound debt management also involves important decisions about the maturity and currency composition of a country's liabilities. To reduce the chances of a sudden reversal in international capital flows, governments should be careful not to finance a current account deficit excessively with short-term debt.

Most countries in the region have opted against a fully flexible exchange rate. As shown most recently by the crisis in Russia, the exchange rate can be an effective instrument for stabilization only if the peg (fixed or crawling) is perceived to be sustainable. However, during transition, the equilibrium real exchange rate changes dramatically as a result of structural changes and shifts in economic uncertainty. Under such circumstances, excessive pegging of the exchange rate can lead to large and persistent misalignments that will threaten the sustainability of the regime and make speculative attacks more likely. At the same time, flexible exchange rates convey little benefits if the underlying macroeconomic imbalances are not addressed, as the resulting volatility in relative prices imposes severe burdens on private investors.

More generally, the potential volatility of international capital flows provides a reminder of the need for a consistent macroeconomic policy mix. Governments cannot hope to address several problems at the same time with the use of a single macroeconomic policy instrument. Monetary stabilization combined with a nominal exchange rate anchor requires complementary fiscal adjustment to be credible. Simultaneously banking sector supervision has to be strengthened to prevent domestic banks from running up large open foreign exchange positions that link the stability of the financial sector to the survival of the nominal exchange rate anchor.

In a number of transition economies, macroeconomic policy is complicated by the existence of large structural imbalances. For instance, fiscal deficits are often associated with the implicit subsidization of loss-making enterprises. Because many of the necessary structural reforms require time, these economies are particularly vulnerable to inflows of short-term risk capital exploiting tensions in the resulting macroeconomic policy mix. While it will be vital for the region to maintain the achievements in establishing current account convertibility, a sequencing of capital account liberalization may therefore need to be considered.

b) Capital controls¹⁷

A gradual approach to financial market integration could conceivably allow economies at earlier stages of transition to reap some of the benefits of exposure to international capital, particularly in its longer-term varieties, while limiting the downside of volatility. The empirical evidence on capital controls suggests that, during the early stages of international financial integration, specific controls on short-term capital inflows have been able to affect temporarily the level and the composition of capital flows.¹⁸

In practice, restrictions on capital flows have taken many forms and have varied greatly in effectiveness.

It is interesting to note that few transition economies have fully liberalized portfolio flows, whereas most lifted restrictions on FDI inflows at the beginning of the transition. Since early in the transition process, most countries have also guaranteed the free repatriation of both profits (current account convertibility) and FDI capital. Treatment of trade credits has also been liberal and in most countries individuals are allowed to hold and operate foreign exchange accounts at local banks, a privilege that most OECD countries accorded only at the latest stages of capital account liberalization. In general, non-FDI-related transactions remain restricted in many countries, there are tighter controls on outflows than on inflows and more serious restrictions on short-term than on long-term transactions. Only the Baltics (and in particular Estonia) opted for a very high degree of capital account openness at the onset of the transition process.

Since 1995 there has been a gradual easing of restrictions on capital movements led by the Czech Republic, Hungary and Poland, as part of their accession to the OECD. Table 13.2 provides indices of liberalization for selected categories of capital flows in the Central and Eastern European countries and the Baltics. They can take values between 0 and 100, with 100 representing the maximum degree of liberalization. The evidence in Table 13.2 shows that within eastern Europe, capital flows have been most liberalized in countries at advanced stages of transition. This part of the region thus conforms to the recommendations of a gradual approach to liberalization. Chile's gradual and selective approach to liberalization

17 The following draws in particular on Temprano-Arroyo and Feldman (1998).

18 The efficacy of capital controls depends on a large number of factors, such as the size of misalignment motivating inflows and outflows, the types of cross-border flows targeted by the controls, the size of trade flows (determining the scope for underinvoicing and overinvoicing as well as for altering leads and lags on trade credit), the structure of the domestic financial system, the state of technology and the efficiency of the controlling bureaucracy (for more detail see World Bank, 1997). In general, domestic residents may be more prepared than foreign residents to evade restrictions, making controls on outflows less effective than controls on inflows.

represents probably the best example from which the region could draw inspiration. In contrast, in Russia and Ukraine capital account liberalization progressed rapidly from the beginning of 1997 against a background of weak fiscal and financial positions, and the results have been destabilizing.

While this evidence supports those arguing for a cautious stance on capital account liberalization, capital controls are not easy to enforce. In addition to the difficulties in recording and monitoring capital account transactions, relying on administrative controls also faces incentive problems, particularly in countries where government officials may have vested interests in maintaining access to budget financing from abroad. A lesson from the Russian crisis may thus be that incentive-based mechanisms to stabilize capital flows should be further explored by the transition economies. This could be done, for instance, by introducing (non-interest-bearing) reserve requirements on international capital flows of less than one-year maturity.

6. Conclusions

Cross-border capital flows support the transition in many ways. The region's economic opportunities and potential as a location for production and as a growing market remain large. Foreign investment -FDI as well as bank lending, bond finance and portfolio equity flows- is helping to develop these opportunities in many transition economies. However, investors will commit themselves to the region only if they encounter a sound investment climate, including stable macroeconomic conditions, and reliable and non-distortionary government policies. Foreign investors are increasingly appreciating the region's growth potential as evidenced by the acceleration of FDI since 1997 -however, it is governments, which through their economic policies unlock this potential.

FDI, after some temporary hesitancy, is likely to grow further, although political stability in Russia is clearly key for this scenario. The prospects for other capital flows are more difficult to judge. The rapid acceleration of 1995-97 was unlikely to be maintained since it was in some part due to a one-off adjustment in perceptions. After the Russian crisis, flows are likely to contract and become far more selective. Countries with sound fundamentals will continue to have access to the international financial markets, if at a higher price. Countries with a reform deficit may not be able to access the markets even at high prices for some time to come.

Subject to continued advance in the transition, and greater security of their assets through the legal and administrative system, investors will be looking particularly closely at fiscal policies. In much of the region, monetary

Table 13.2
**INDICES OF CAPITAL ACCOUNT LIBERALIZATION IN CENTRAL
 AND EASTERN EUROPE AND THE BALTIC STATES^a**
(position as of December 1997)

	Albania	Bosnia and Herze- govinia	Bulgaria	Croatia	Czech Republic	Estonia	Mace- donia	Hungary	Latvia	Lithuania	Poland	Romania	Slovak Republic	Slovenia
Controls on:														
FDI ^b	68.7	33.3	66.7	83.3	100.0	100.0	66.7	100.0	100.0	83.3	100.0	83.3	83.3	83.3
Real estate investment	75.0	0.0	50.0	0.0	50.0	75.0	0.0	75.0	75.0	50.0	50.0	0.0	50.0	50.0
Credit operations ^c	0.0	50.0	37.5	83.3	82.5	100.0	37.5	75.0	100.0	62.5	75.0	0.0	37.5	37.5
Portfolio flows	0.0	0.0	25.0	35.0	70.0	100.0	0.0	33.3	100.0	100.0	35.0	0.0	25.0	25.0
Overall index of liberalization of the capital account	16.7	17.6	35.3	44.4	73.7	97.6	23.3	59.5	97.6	85.7	55.3	12.5	23.7	40.5

Source: Temprano-Arroyo and Feldman (1998).

^a The index can take values between 0 and 100, with 100 representing the maximum degree of liberalization of capital flows under consideration. The index for a given country is constructed by adding up the values contained in each category of capital flows and dividing the total by the maximum possible score. Flows not subject to controls are assigned a value of 2; flows classified as being subject to partial controls are assigned a value of 1; flows subject to serious controls are given a value of 0. When information on a given capital transaction is not available, a value of 0 was assigned to both the numerator and the denominator.

^b With the exception of sectors normally considered sensitive or of strategic national interest.

^c Borrowed or extended by residents other than banks.

policies have led the way in restoring macroeconomic stability resulting in, at times, extraordinarily high real rates of interest. If the macroeconomic position is to be secured, the fiscal position must be put on a sound long-term basis. As on most dimensions of the transition, improving policy on the fiscal front requires not only careful attention to building institutions, but also promoting and enforcing responsible behaviour both inside and outside government.

Given that the fiscal and structural reforms underpinning improvements in the investment climate may take time to become fully effective, in the short-run, some of the less advanced transition economies should carefully consider when to lift restrictions on capital flows. In particular, incentive-based mechanisms to discourage excessive short-term capital flows may provide a useful policy tool to contain volatility. However, ultimately, while access to international investment offers significant benefits, it provides no substitute for structural reforms that encourage the mobilization and more effective utilization of domestic resources.

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14. CRISIS AND CONTAGION: SOME NEW AND OLD IDEAS

*José Luis Machinea **

1. Introduction

With the succession of booms, crises and contagions of recent years, and the great variability and violence of international capital flows, the idea that it is essential to discuss, design and organize a new architecture for the international financial system has become almost a commonplace. In the present agitated climate I would like to deal here with some issues from recent discussions on possible and necessary reforms. Following on from the more general account given by José Antonio Ocampo in Chapter 2 in this volume, I shall concentrate just on some particular points.

First of all I shall consider how this debate began and what events led the political, academic and economic worlds to raise these questions. Then I shall analyze the main issues raised, in particular the importance of the discretion enjoyed by the lender of last resort and the problems of moral hazard associated with this, the role of the IMF as the world lender of last resort and, finally, the importance of prudential regulations and transparency.

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2. The main subjects of discussion

For scarcely more than 18 months, the debate in emerging countries regarding the international financial system has been confined to four central issues, that stemmed directly from the extreme volatility of international capital flows:

- What can emerging countries do to limit the volatility of capital flows?
- How can macroeconomic stability be maintained when there is so much volatility?
- How can financial systems be made solid enough to withstand this volatility?
- How can a crisis in the financial system (caused by the volatility of international capital flows) be inhibited from spreading to the rest of the economy?

As regards the first of these issues, discussion focused around the advantages and disadvantages of placing restrictions on capital inflows, with both Chile and Colombia being cited as case studies. There was no consensus as to what policy it was best to follow. Some supported the introduction of restrictions *à la* Tobin, but with concerns about the microeconomic distortions this could produce. There was, on the other hand, universal agreement about the importance of having a solid macroeconomy and financial system to cope with capital volatility. Discussions on the best method for achieving this, invariably leant towards the idea of 'self-insurance': what criteria needed to be met in terms of taxation and spending, the external sector and the financial system for achieving the objective.

In this presentation we shall concentrate on the fourth of the points referred to: how can a crisis in the financial system (caused by the volatility of international capital) be inhibited from spreading to the rest of the economy? There used to be an extremely simple formula for this, one which was advocated by some international bodies, among others. The diagnosis was that crises in financial systems had led to a great expansion in the amount of money, and that this in turn had produced inflation. What else was there to be done, then, but to ensure that the amount of money did not expand?

This recommendation had a great influence in some countries, and particularly in Argentina from 1991 to 1994. It led to the reform of the Charter of the Central Bank of the Argentine Republic (BCRA), the practical effect of which was the elimination of the role of the BCRA as lender of last resort. For the first time in history, this function was abolished by law; the BCRA simply could not lend. This experiment came to an abrupt end, however, as soon as a crisis arose, whereupon the Charter and the Law on Financial Institutions (*Ley de Entidades Financieras*) were rapidly reformed and a safety net was created in the financial system.

3. Since the latest international financial crises

The most recent crises in the emerging countries gave rise to a fifth subject of discussion, one of no less importance but of a somewhat different nature. There was debate in international circles about the appropriateness of large aid packages and 'jumbo' loans such as the one Mexico received after the 'tequila crisis', and the type of conditions that the IMF ought to impose on beneficiary countries.

The main problem that emerged when loans of this type were made was the moral hazard that arose when in some way or other the aid ended up 'rescuing' investors. There was also discussion of the moral hazard that these packages entailed for the countries themselves. Although this line of argument follows the same logic as the previous one, in reality it is implausible. Nobody can seriously think that a government, coalition or opposition can be so rash as to seek out a situation of crisis that entails a devaluation of 80%, a 40% drop in real wages and a recession of 6 percentage points of output, simply because, in the last resort and after such a succession of catastrophes, international agencies will be there to provide new funding. It is hard to believe that countries might be tempted to act irresponsibly just because they know that the International Monetary Fund (IMF) is there to make loans of this kind, and I believe that the real effects of crisis are so serious that they cannot be made up for by a subsequent inflow of capital, however generous.

The very usefulness of the IMF was discussed. In my opinion, it was a good thing the IMF was there. Leaving aside what is debatable about it -the conditions it imposed when it acted, the changes that could be made to its intervention procedure and the reforms that are needed- the crisis would undoubtedly have been far more acute had it not been there. These crises also raised the question of information: Were Mexico's reserves known? Did Korea hide information from the Fund? Information, transparency and other kindred subjects were given greater importance. Later on we shall deal in greater detail with prudential regulations and standards of conduct.

Then came the crisis in Russia, which proved to be more complicated: there was a major default and a contagion that spread almost indiscriminately across Asia, Latin America and indeed virtually every emerging market. This situation led to great volatility in capital flows, to the extent that even the American economy was put in some danger. It is interesting to observe the cause of this danger: the risk to the United States arose not because a large bank fell, but because of the collapse of a hedge fund which shook the international financial system.

With this débâcle, the true scale of the problem really began to be grasped: to limit the negative consequences of volatility and contagion, it was not enough simply to have solid macroeconomies and financial systems, better information and greater transparency, improved prudential regulations and jumbo loans after the event. Something else had to be done.

4. Moral hazard and the role of a local lender of last resort

The contagion that followed the Russian crisis was really serious, with severe effects on the liquidity of the financial system. What do economic theory and practice have to say about a situation where contagion threatens liquidity? An initial response is the one that came out of the dissimilar but equally instructive experiences of the United States and England in the last century:¹ the idea of a lender of last resort -and, better still, the creation of a safety net guaranteeing intervention in a crisis, ultimately upheld by this lender.

Given the problems of incentives, information and monitoring that distinguish the financial market from all others, the idea of self-insurance proved not to be the most efficient way of organizing markets of this type. There has thus been a renewed debate about the problems faced by a lender of last resort, which have been discussed again and again over the last 150 years, and with particular intensity over the last 30: moral hazard, rules vs. discretion, etc. Virtually all the relevant subjects can be found in the existing literature.

The idea of moral hazard applies to investors on the one hand, and to banks and countries on the other. How has the question of the moral hazard of investors been resolved at the national level? Two instruments have been used. Small investors, who have less knowledge of the market, are protected by a guarantee on their deposits, while for the rest there is a lender of last resort which can also apply some additional instruments in cases of crisis.

In all these arrangements, a peculiar feature stands out: the discretion enjoyed by the lending authority. The Central Bank has to decide when and how to intervene. The type and scale of intervention will depend on the severity of the crisis, and in particular on how powerful the contagion effect is or is expected to be. Discretion is important, so that investors cannot rest assured that they will recover their investments. The moral hazard of investors, then, is dealt with in part by the discretion allowed to the relevant authority.

1 In the case of the United States, which had no lender of last resort, there were seven very severe banking crises which led in some cases to the banks remaining closed for a prolonged period. In England, which had the Bank of England as a lender of last resort, there were only two crises, and these were relatively minor.

However, an unwanted side-effect of the uncertainty produced by this discretion, which enables moral hazard to be reduced, is that it does not exclude the possibility of a systemic crisis being triggered. The choice of what to do in each case will depend on the assessment made of the magnitude of the systemic risk. What the authorities must not do is tie the hands of the Central Bank by not only stating that it will not intervene, but enacting a law to this effect, as was done in Argentina in 1991. There is no such thing as non-intervention regardless of the circumstances: all those who have stated that they will not intervene have in fact ended up by doing so, examples being Chile in 1981–82 and Argentina in 1995.

On the other hand, though, the moral hazard dilemma also has a side that concerns banks and countries. As I have already said, I do not believe that this problem really exists where countries are concerned; what is more, I do not believe that talking about moral hazard is particularly relevant in the case of banks either. This is due to the simple fact that the relevant authority can decide to keep a bank open by bailing out the institution without thereby bailing out the bankers. So if the bankers are not ‘rescued’, I do not really see where the moral hazard comes from.

5. Is it possible to have a world lender of last resort?

a) *Discretion...*

Where moral hazard is concerned, much the same analysis applies for international investors as for local ones. By contrast, the analysis of the moral hazard of banks cannot be extended in a linear fashion to that of countries, except, perhaps, regarding how overstated and overrated the problem of moral hazard is in both cases. While a lender of last resort can use its discretion in the case of banks, this is much more difficult where countries are concerned. At the country level, the possibility of carrying out something akin to the discriminating bailout that we mentioned earlier does not exist. How can the IMF or any other international body acting as the world lender of last resort have the power to act differently towards different countries, saying ‘yes’ to one and ‘no’ to another?

When the subject is thought through to this point, it becomes clearer that setting up a lender of last resort for the whole world may not work because, at least for the time being, it is impossible to construct a supranational body that enjoys the powers and discretion of a Central Bank. This key difference between the international financial system and national systems weakens the idea of a world lender of last resort.

b) ... or rules of eligibility

When we come to terms with this serious problem, when it really becomes clear that this kind of discretion has to be ruled out, we discover that rules come to play an even more preponderant role. Discussion of rules leads on to other subjects, among which I believe that *eligibility* -the ability to decide whom to help and whom to stop helping, and why- is absolutely central.

There are two types of criteria for determining eligibility. The first of these is couched in terms of a set of variables, such as for example fiscal and current account imbalances, the level of the exchange rate and short-term borrowing, among other things. I believe, however, that it might be simpler to use what may well be a complementary criterion, which is the fact of whether the country concerned has a programme with the IMF or not. If a country does not have such a programme and is in a position of reasonable balance in the set of variables referred to above, which must have been audited by the IMF under the supervision procedure provided for by Article 4, when a contagion takes place, this country should become entitled more or less automatically to the assistance of international lending agencies.

With this prescriptive approach, however, assistance would be given only to countries that had these basic balances and were not in a programme with the IMF. The IMF also needs to be able to help those countries that have imbalances and are in a programme as a result, when they are meeting agreed targets adequately but fall victim to a speculative attack deriving from contagion. Cover needs to be given, then, not only to countries that have no agreement with the Fund and that are willing to be supervised by it, but also to those that are complying with agreements (Standby or Extended Fund Facility).

The idea proposed is a design for the international financial system that is based on three pillars. The first of these would be the traditional agreements. The second would be greater use, particularly in the present economic circumstances, of the contingent credits employed when there is a decline in the terms of trade. The third, finally, would be a system equipped with a set of contingent credits to deal with problems that arise in the capital account because of external shocks and contagion problems. Thus, eligibility could be determined using the traditional IMF methodology: Article 4 of consultation and supervision, on the one hand, and countries covered by agreements that are in compliance with it, which could thus make withdrawals directly, without additional requirements that would only complicate matters.

In this way, the architecture of the financial system would be supplemented by contingent credits that could be used by countries undergoing severe liquidity crises that might lead to contagion effects. This option circumvents the issue of supranationality that arises when there is a

lender of last resort with discretionary powers, but at the same time prevents critical situations from getting out of hand in cases where there are no solvency problems. Moral hazard, meanwhile, is confined to the conditions 'without major imbalances' or 'with imbalances that are being resolved', which would be like the Central Bank awarding banks in the local financial system a 'good mark'.

With this arrangement, the liquidity of multilateral bodies is vital. Contributions ought to rise, since at constant prices they are now much lower than they were at the early stages of Bretton Woods. Apart from this, though, there are a number of interesting and innovative proposals for increasing liquidity, for example by using special drawing rights (SDRs), which would be issued by the Fund when severe crises arose and then reabsorbed.

6. Prudential regulations, information and transparency

Prudential regulations are vital to the financial system, and there should be standardized international criteria that lay down stricter requirements for countries with a higher degree of volatility. Developed countries should address the need to regulate hedge funds, either directly, or indirectly by limiting what banks can lend to funds of this type; I do not think there is enough discussion of this point at present. In developing countries, the needs are clear: prudential regulations have to deal with concentration, the scope of guarantees and term mismatches, among other issues. But there are also greater capital and liquidity requirements. In Argentina, for example, capital requirements are 14% of assets, which is higher than the 8% established by Basle, and liquidity has to be equivalent to 20% of all liabilities.

Although requirements of this type clearly need to be stricter in developing countries than in developed ones owing to their greater volatility, the question is where to stop. At the extreme, economies with a record of greater instability could have very solid financial systems ... that were of no use at all. With capital and liquidity requirements of 50%, this hypothetical financial system would be immune to any kind of shock, but what would be the use of it? It is obvious that there is a clear trade-off in this respect, and there is apparently no completely satisfactory way of determining where the ideal point of balance lies.

Another two key issues are those of information and transparency. We can distinguish between two types of transparency:

- the transparency that should obtain in exchanges of information between banks and regulators and between countries and international agencies

- public transparency, the knowledge about organizations that should be made available to the public at large.

The commonly accepted idea is that the more information and transparency there is the smoother the cycle will become. Thus, for example, the appearance of unfavourable indicators during the upswing would moderate the cycle. I agree with this idea, however, if inadequate indicators are observed we can have further instability. So this casts some doubts over the idea that making information public will moderate cycles during the upswing.

But there is another problem as well. In the downswing of the economic cycle too much information can be dangerous. For example, let us suppose that the deposit levels and profitability of each bank are published on a daily basis, at a time when they are losing deposits and profitability is falling. In Argentina, for example, there was a regulation, which was never implemented, establishing that banks had to display the mark they had received from the rating agencies in the foyer of every branch. Imagine the effect it could have on a bank whose portfolio was deteriorating because of crisis and recession if its employees were seen by investors replacing the 'AA' placards in the foyer with 'BB' ones.

In summary, people should be careful with the indicators they look at in the upward cycles, and I fear that in downward phases too much information could worsen the situation, multiplying the effects of runs on the market. I agree on how important it must be to have more and better information, but I believe that it must be made public with the greatest caution.

15. CAPITAL FLOWS IN CHILE: CHANGES AND POLICIES IN THE 1990s

Carlos Massad *

1. Introduction

This chapter examines both international financial globalization in a general way and the Chilean policy of capital account liberalization *vis-à-vis* foreign markets undertaken during the 1990s. Though it focuses primarily on Chile's experience of the turbulence that resulted from the Asian financial crisis set off in mid-1997, the major subject of discussion at a global level has been how to define a new architecture for the international financial system and how to deal with the limitations that such an undertaking must face.

Globalization has been the salient financial phenomenon of the 1990s, a decade driven by technological change, featuring the development of means of communications that shrink distances and make the world more unified. In the case of Latin America, the net flow of private capital moved from average levels close to zero in the second half of the 1980s to US\$ 46 billion in the 1990–96 period, and to almost US\$ 90 billion in 1997. In 1998, there was a decline of 12% as a result of the international crisis. For all developing countries, the net flow of private capital in 1997 was approximately US\$ 130 billion, seven times the average for the second half of the 1980s, and not far from the 1990–96 average. 1998, however, saw a drop of more than 30%.

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Globalization is good for development and opens up many opportunities for a country like Chile, which is seeking to overcome underdevelopment and poverty. However, globalization also involves significant risks and must be handled with the utmost care. Because there are risks of serious macroeconomic and financial imbalances, a policy of financial liberalization *vis-à-vis* foreign markets must be prudent and gradual, though the risks should by no means prevent a country's taking advantage of the opportunities that the globalization process offers.

In the course of the 1990s, Chile has taken great steps forward, including a return to democracy and unprecedented success on the macroeconomic front, salient among which are a reduction of inflation to under 5% annually, average economic growth rates of over 7%, and the preservation of foreign trade balances. This has stimulated an influx of foreign currency, and it provided a continuous source of strength for the Chilean peso between 1990 and 1997. The government intervened to moderate the real rate of appreciation of the peso in order to maintain an exchange rate consistent with an equilibrium in foreign trade –i.e. to maintain a sustainable medium- and long-term position in the current account balance.

Two periods can be distinguished within the 1990s in terms of capital inflows. The first, which ran through the first half of 1997, featured large inflows against a background of international economic stability. The second, beginning in July 1997, took place in the context of the international crisis triggered by the financial crisis in Asia, and featured a significantly reduced flow of funds to emerging countries.

It can be seen that the effort to stabilize the exchange rate during the first period was fully justified when the international situation became more volatile and the worsening and spread of the Asian crisis produced a significant impact on the Chilean economy, with reduced demand for export products and worsened terms of trade –around 12% lower in 1998 than in the previous year.

Table 15.1
COMPOSITION OF NET CAPITAL FLOWS, 1990-98
(millions of US dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total net flow	2,902	946	3,086	3,143	5,337	2,410	5,457	7,430	3,193
Net foreign investment	654	697	538	600	1,672	2,220	3,561	3,467	1,994
New portfolio investment	361	189	458	730	908	36	1,098	2,370	-727
Medium and long-term loans	679	-291	204	522	1,325	-247	506	3,276	3,349
Short-term loans	1,208	352	1,886	1,292	1,431	401	292	-1,683	-1,423

Source: Central Bank of Chile.

The crisis also reduced the net inflow of capital through reallocation of funds in foreign investors' portfolios and as a result of the efforts of Chilean investors to protect themselves from the exchange rate risk to which they were heavily exposed owing to the long period of appreciation in the peso. Thus, the capital flows that characterized the period beginning in 1990 took a turn in 1998, with foreign direct investment (FDI) dropping to approximately US\$ 4.8 billion from a figure of US\$ 5.4 billion the previous year. Portfolio investment fell to US\$ 693 million, a third of the 1997 figure. Chilean investments abroad, on the other hand, doubled in 1998, reaching approximately US\$ 4.2 billion. In net terms, capital inflows to Chile fell to US\$ 3.2 billion, nearly half the 1997 figure (see Table 15.1).

2. Financial integration policy: benefits

Throughout the 1990s, Chile has maintained a gradual and sustained policy of economic liberalization in order to cover its financing needs and take advantage of the long-term benefits of financial development. However, there must be an effort to minimize the side effects of financial integration –including changes in macroeconomic stability– which can occur when changes in net capital inflows are too abrupt. Among the main benefits of financial integration with foreign markets are (a) the possibility over time of stabilizing the consumption profile of individuals at less cost than is involved in the case of a capital account with restrictions, complementing domestic saving efforts with foreign savings, and thereby accelerating investment and growth; (b) the possibility of diversifying risk by acquiring positions in assets and debt the risks of which differ from what is available on the domestic market, reducing the volatility of domestic revenue and consumption; (c) the possibility of supplementing residents' investments with foreign investment, using new technologies to exploit and manage resources; (d) facilitated access, via foreign investment, to new markets where the comparative advantages of Chilean productive sectors can be taken advantage of; and (e) the possibility of delivering more efficient and complete financial services for domestic users by opening the field to competition by foreign players.

3. Financial integration and the accentuation of economic cycles

Notwithstanding these benefits, it should be borne in mind that financial liberalization involves a number of challenges and risks, especially for a small economy. In the first place, there is the issue of the transition from a capital account that is closed or lacks access to international markets, to an open one that may trigger a massive entry of capital. Such inflows are reactions both to

whatever differentials there may be between domestic and foreign interest rates and to adjustments in the composition of portfolios which foreign investors make to balance risks and yields and achieve their performance goals. This process can generate excessive increases in prices of domestic assets, which in turn can generate unsustainable increases in domestic aggregate demand, with consequent upward pressure on prices of non-tradables and on the current account deficit. These are transitory phenomena, since the inevitable correction in domestic demand forced by the deterioration in the external accounts will end up bursting the bubble of domestic assets prices, forcing a correction that may be painful and can entail recession.

This, indeed, was the case with financial integration in Mexico in 1994–95, Asia in 1997 and Russia in 1998, where changes in expectations of returns on assets, hedging strategies and fear of contagion led to increased volatility in markets and to considerable reversion in capital flows and in the prices of domestic assets.

It should be borne in mind that in an open economy receiving a strong influx of foreign capital, monetary policy cannot prevent the expansionary effect of assets prices, since monetary policy loses some of its autonomy and effectiveness in controlling domestic demand. In this phase of the capital flow cycle, the reduction of the relevant foreign interest rate generated by the demand of foreign investors for domestic assets combines with optimism about the expected exchange rate to create an abundance of capital with consequent upward pressure on the value of the country's currency. This limits the effective range in which monetary policy can raise the real interest rate.

Regulations and policy relating to the capital account make it possible, to some extent, to insulate the domestic capital market –especially short-term capital– so that monetary policy regains some latitude to operate with interest rate increases. Thus, there can be at least a partial improvement in the ability to control expansion of domestic spending, as the Chilean experience has shown.

Now, experience has shown repeatedly that the solidity of the financial system is a key to moderating the cyclical impact of capital flows. A financial system with an inadequate regulatory structure amplifies cyclical phenomena in the economy. Badly supervised banks or superficial approaches to risk management lead to a tendency to finance excessive growth in consumption and speculative investment in the expansion phase, which creates an inefficient allocation of resources and encourages excessive risk, leading to a financial crisis in the declining phase of the cycle when the price of assets falls.

Asymmetries and limitations on information play an important role in amplifying economic cycles generated by financial intermediation. In particular, according to some observers, globalization complicates the selection of investments, given the larger menu of available assets, and makes

it more expensive and difficult to acquire information on individual investment opportunities. The lack of direct information stimulates herd behaviour, where investors that are not well informed imitate other investors, in fact basing decisions on information not within their own ken. In the banking sector, limited information can lead to adverse selection of borrowers, a phenomenon which occurs when there is little information on the quality of borrowers. This leads to a tendency for banks, in this type of situation, to lend funds at interest rates reflecting the risk of an average borrower. Such loan management constitutes a disincentive for low-risk enterprises to acquire debt, while stimulating high-risk enterprises to become overindebted. Finally, the problem of excessive risk-taking or 'moral hazard' occurs when the losses of a project are mostly assumed by the creditors of the enterprise, while gains are received by owners and managers. This problem is common where there is a lender of last resort for the financial system (a central bank) where supervision is inadequate. The result is excessive risk-taking by borrowers and financial institutions and it is especially accentuated when there is an abundance of foreign funds, tending to amplify the cyclical effect of capital inflows.

Thus, a large influx of capital can mean an excessive rise in aggregate demand, with negative impact on the financial system and exacerbation of economic cycles. The problem is aggravated when regulation, supervision and transparency of financial markets are not up to the mark. There must therefore be financial regulations capable of guaranteeing appropriate volume and efficient allocation of resources.

4. Changes in the regulatory framework in Chile

Bearing in mind the advantages and disadvantages of integration with foreign markets, the policy of liberalization carried forward by the Chilean government in the course of the 1990s has maintained a very strict system of financial supervision, limiting risks in the financial system, and has put in place a set of regulations covering the liberalization of the capital account. The regulations have aimed to control the degree of integration of domestic and foreign markets, and to give priority to the most rapid advance in the integration of direct investment and medium-and long-term debt. The policy instruments used have been foreign exchange regulation and capital flow regulation.

In the area of foreign exchange regulation, it should be emphasized that this market has been in a continued process of change throughout the 1990s, moving from a dual market -informal and formal- toward an ever more unified one. The law establishing the charter of the Central Bank defines the formal currency exchange market, in which the Central Bank, commercial

banks, currency exchange firms and other authorized entities participate, and provides authority to regulate the market. Regulations define exchange transactions and determine how they must be carried out. The dual approach to the market was gradually modified during the 1990s. Confidence in the Chilean economy and the stability of its foreign accounts has made it possible to reduce exchange restrictions, particularly those affecting foreign trade, allowing for the unification of the two markets, which is reflected in the fact that since 1996 there has been no price differential between them.

As to regulation of capital flows, the approach has been to (a) reduce inflows to amounts considered 'digestible' by the economy; (b) maintain a degree of independence in terms of monetary policy; (c) reduce the volatility of capital flows out of and into Chile; and (d) maintain a solid external financial position at the national level, both in terms of liquidity and in terms of solvency.

The most important regulations are those governing capital inflows and they are categorized by type of transaction: loans, FDI, portfolio investment. Salient among these regulations are the unremunerated reserve requirements for portfolio investment and debt (URR), in effect from 1991 to 1998, a minimum one-year period of permanence in the country for investments in general, and minimum amounts and risk classification conditions for issuers of bonds and ADRs. The URR, which stands at a rate of 0% since September 1998, aims to compensate for the differential between domestic and foreign interest rates, reducing opportunities for arbitrage by increasing entry costs, thus discouraging short-term capital inflows and providing more independence for monetary and exchange rate policy. Regulations preventing quick re-exit and mandatory minimum time periods of permanence aim to discourage inflows of speculative capital and to restrict the liquidity of foreign institutional investors so as to avoid temporary and excessive entry of such capital. The minimum amounts and the risk classifications conditions have been aimed at reducing the possibility that a Chilean enterprise issuing debt or equity on international markets will find itself unable to meet its foreign commitments, thus generating negative effects on financing opportunities for other local firms. To the extent to which domestic and foreign conditions, and in particular the development and deepening of capital markets that trade securities of Chilean firms, have allowed it, these requirements have been relaxed.

The rate of the URR reached 30% in the mid-1990s, and was gradually reduced to 0% as external financing became more expensive; thus, the URR has been used as an anti-cyclical instrument, preventing the accumulation of short-term debt and thus stabilizing outflows in difficult times. The rate of the URR could be increased to positive numbers again as circumstances require.

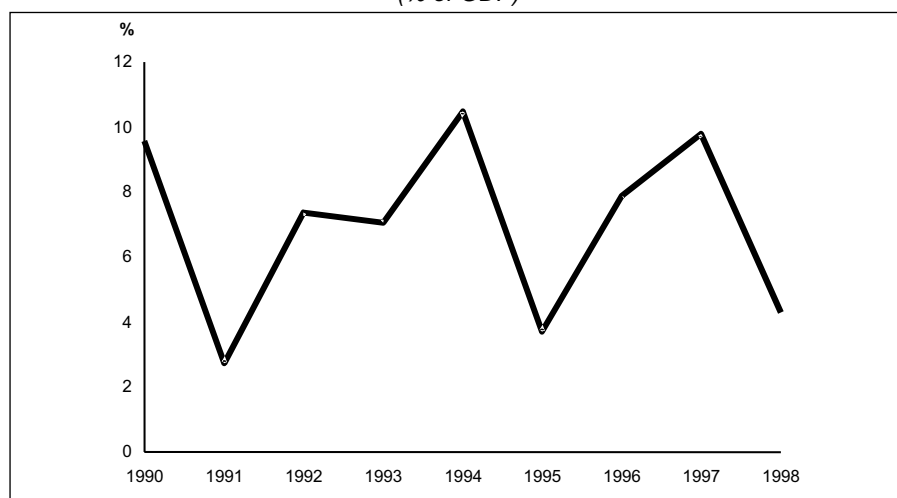
Capital outflows, which have been categorized by agent – individuals and firms, institutional investors, banks and exporters– have been closely linked with foreign exchange restrictions. The restrictions have gradually been lifted as conditions have permitted, and outflow of capital is generally unrestricted now through the informal exchange market, though there are still limitations on the access of individuals and firms to the formal market. In the case of banks and institutional investors, there are maximum amounts for holdings of foreign assets, but these requirements are related to prudential regulation, not to foreign exchange regulation.

5. Capital flows

The favourable position of the Chilean economy in international markets is evident in the pattern of capital inflows. While the average influx was 6.8% of GDP in 1990–95, the 1996–97 period saw an increase to 8.8%. The level fell to 4.3% in 1998 as a consequence of the Asian crisis and its aftermath in emerging markets (see Figure 15.1).

The Southeast Asian countries, without capital flow controls before the crisis, had inflows on the order of 10% of GDP. Following the crisis, and as a consequence of the high volatility that the maturity composition of the capital flow represented for these countries, there began to be a net capital outflow, making the domestic economic situation critical.

Figure 15.1
FLOWS OF CAPITAL INTO CHILE
(% of GDP)

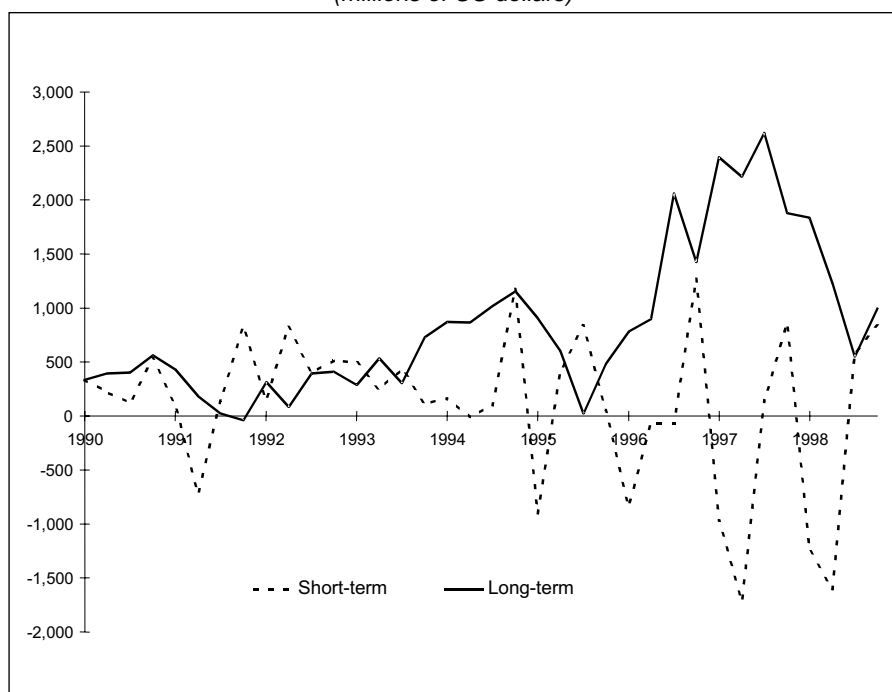


Source: Central Bank of Chile.

As a consequence of measures tending to discourage inflows of speculative capital in Chile, there has been an important change in the make-up of the capital account, giving solidity and stability to the liberalization process: while in 1990 23% of capital inflows were medium-term and 42% were short-term credits, the 1997–98 period showed 62% of flows being medium-term credits, with short-term flows showing a net outflow (reduction of stock) equivalent to 29% of the total capital account.

A capital flow more skewed toward the long-term means a reduction in the standard deviation of the total flow. The long-term component has grown on average in the last few years. In this same period volatility, measured as the standard deviation of the growth rate of the variable in relation to its mean value, has been approximately 85% for the total capital flow. This breaks down into a volatility of around 80% for net long-term flows and almost 300% for net short-term flows. Figure 15.2 shows the change in these variables in the 1990–98 period, illustrating precisely the difference in the variability of flows.

Figure 15.2
NET CAPITAL FLOWS
(millions of US dollars)

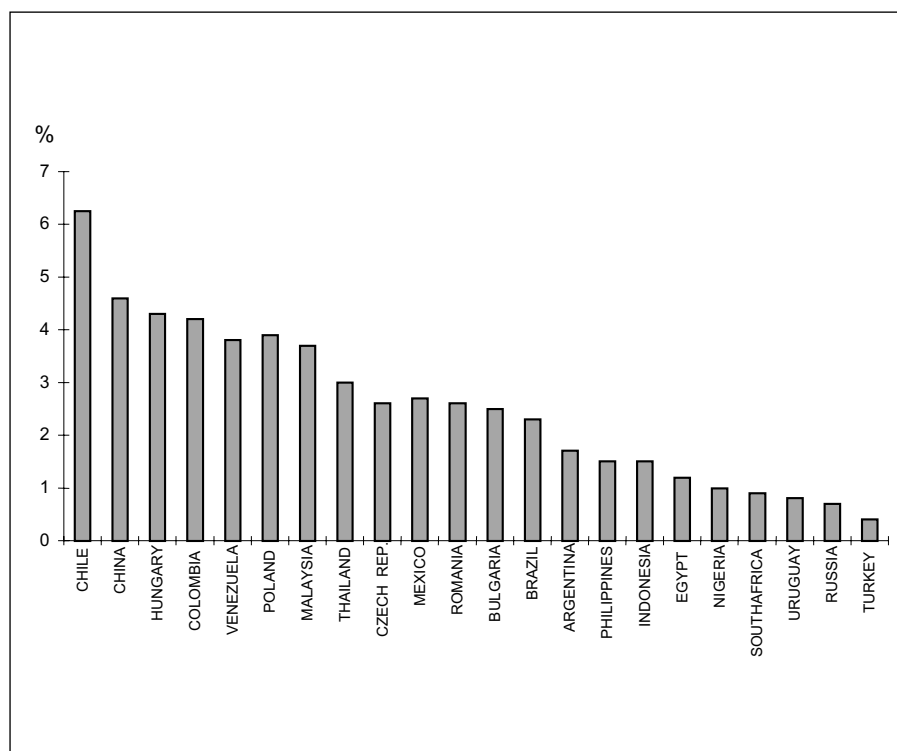


Source: Central Bank of Chile.

FDI has shown great strength, increasing in relation to foreign debt. While in 1990 35% of flows were FDI, the 1997-98 figure was over 60%. It should be noted that these figures include Chilean investment abroad, which has grown from year to year, both for institutional investors and for firms and individuals.

Owing to its long time horizon, FDI is strongly associated with perceptions of economic and political stability on the part of investors. Chilean indicators, in this respect, are extraordinarily positive. FDI into the country averaged close to 7% of GDP for the 1996-98 period. This is approximately double the figure for the rest of Latin American countries and Southeast Asian countries, and is roughly 50% above the levels in Eastern European countries such as Poland, Hungary and the Czech Republic (see Figure 15.3).

Figure 15.3
FDI AS PERCENTAGE OF GDP
(average 1996-98)

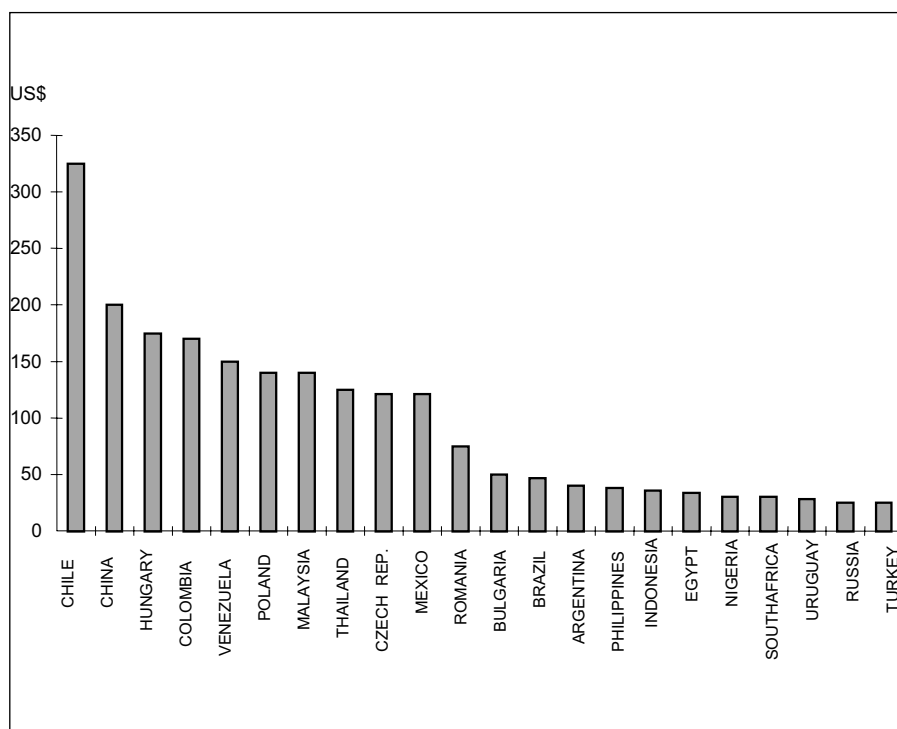


Source: International Monetary Fund.

It should be noted that the variability of FDI in Chile with respect to its mean growth rate, which is in the neighbourhood of 40% for the 1990–98 period, is significantly less than the variability of the other components of the capital account. This is owing to the fact that, as indicated, FDI is based on structural variables in the economy, being of a long-term nature.

Expressing FDI in *per capita* terms, as in Figure 15.4, we see that Chile's position is extraordinarily solid. If we compare these figures with 1993–95, we see that there is a fairly generalized increase, reflecting a more globalized world. For the case of Chile in particular, we have a doubling, as in the rest of Latin America, which is strongly influenced by the privatization process in Argentina and Brazil. In the case of Eastern Europe, the aggregate growth of *per capita* foreign investment is approximately 40%.

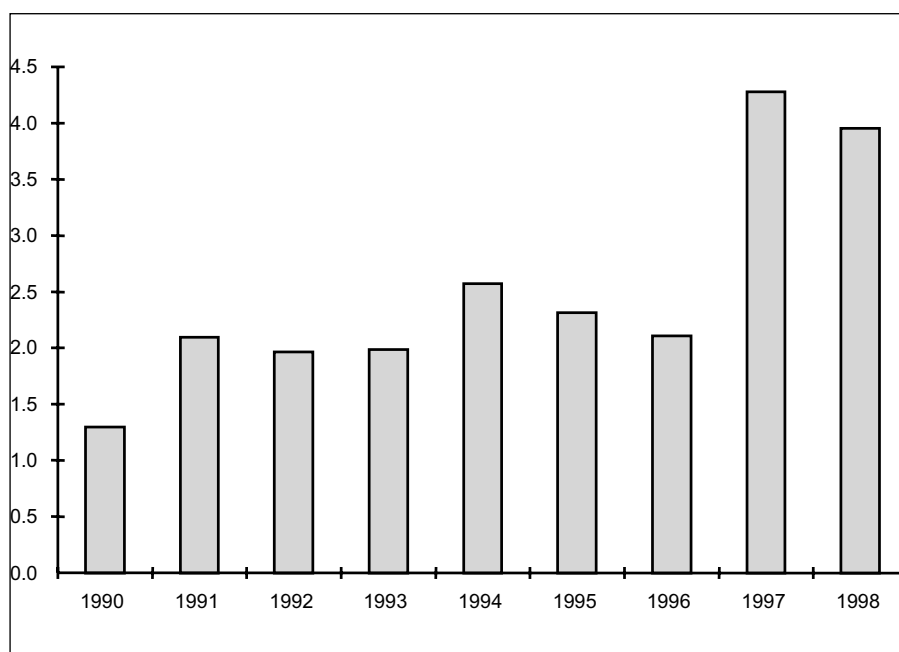
Figure 15.4
PER CAPITA FDI
(average 1996-98)



Source: International Monetary Fund.

The solidity of Chile's foreign accounts results in indicators that reflect low vulnerability. Chile's reserves are four times the short-term foreign debt plus amortizations for the current period (see Figure 15.5). According to the data shown in Figure 15.5, this indicator is similar to values for the last two years, and approximately double the level for the first half of the 1990s. The lower vulnerability reflected by this indicator leaves the Chilean economy in a stronger position to confront foreign shocks, which produce lower capital flows, as in 1998, and to deal with low prices for primary products.

Figure 15.5
RESERVES/SHORT-TERM FOREIGN DEBT AND AMORTIZATIONS



Source: Central Bank of Chile.

This indicator for the rest of Latin America and Asia is 0.8 and 1.1, respectively. Chile's reserves today are half of the total foreign debt, while the figure for the rest of Latin America is one-quarter and the figure for the Asian countries in which the crisis began is somewhat greater than one third. This strong position is making it possible to avoid the pitfalls created by the current crisis in such a way that the national economy is now positioned for recovery following a temporary slowdown in its growth rate.

6. Conclusions

The positive economic achievements of the country during the 1990s confirm the quality of the economic policies that are in place. In particular, gradual and sustained liberalization of the capital account has proven to be a successful approach. Since 1998, the country has faced an international crisis with heavy impact on commodities prices, but unlike other moments in the country's history or what has happened to other countries in this crisis, Chile's foreign accounts are strong and the economy is moving beyond the crisis with only a transitory levelling trend in the growth rate. In the midst of a depressed international scene, where foreign conditions are only beginning to stabilize, it is advisable to maintain cautious policies looking to the long term. The policy of the Central Bank attempts to encourage gradual but lasting recovery of economic growth, preserving macroeconomic stability and reaffirming a commitment to gradual but sustained reduction of inflation, as well as reasonable equilibrium in the external accounts.

Well managed financial integration makes it possible to take advantage of the much broader opportunities offered by a world of advanced globalization, where more and better international trade is possible, along with sustained economic growth and a gradual convergence toward the standards of living of the developed world. All this is of the greatest importance for developing countries like Chile, which seek to overcome poverty and offer equal opportunities for advancement to all of their inhabitants. Only through sustained growth, achievable if these opportunities are exploited, can the challenge be met. The decade shows clear indications of growth in this sense, as Chile's poverty indicators have fallen to less than half their previous levels, and many indicators in the social areas of education and health show significant improvement. The maintenance of policies that contribute to achieving sustained growth in a stable context is the best contribution that the monetary authority can make to the country, providing the soil for ongoing progress in this area.

In a seminar organized by the Jacques Maritain Institute, explicit consideration of the questions of values implicit in our approach is especially necessary. In the words of Maritain, 'The practical sciences seek knowledge not for its own sake, but to achieve by action the good of man (a good distinct from the pure act of knowing the truth)'.¹

For Maritain, nature has laws that may be immutable, but events are not immutable, since they are influenced by multiple causes in the spatio-temporal dimensions in which they exist. Thus, events are a combination of nature and venture in which man's own freedom plays a

1 Maritain, J. (1985) *Introducción a la Filosofía*, Buenos Aires, Club de Lectores, p.225.

central role. Human beings, not policies themselves, are our centre of attention and the target of our ethical concerns. This means that we must adapt to changing circumstances, and that flexibility is not only technically advantageous but is also an ethical obligation to our fellow citizens.

16. ECONOMIC POLICY OPTIONS AND FINANCIAL GLOBALIZATION: MEXICO, 1988–99

*Rocío Ramos de Villarreal**
*René Villarreal***

*Emerging markets are relatively
small boats in a turbulent sea.*

(Jeffrey E. Garten, 1999)

1. Introduction

Mexico like Latin America as a whole is experiencing an economic crisis that has three dimensions:

- The *crisis is systemic in nature* due to the financial globalization which generates inflows and outflows of speculative short-term and volatile capital which have an impact on the adequate level of reserves that these countries have to maintain, as well as on their savings/investment ratios, macroeconomic stability and economic growth itself.

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- It constitutes an *unfinished transition* due to the fact that the old statist model of inward-oriented industrialization and growth via import substitution industrialization has been inoperative since the mid-1980s, and the new system based on a more open economy and an open and competitive industrialization has yet to be fully born, that has led to recurrent crises, as illustrated by the experience of Mexico in 1982, 1986 and 1994.
- The *crisis is of long-term vision* due to the absence of integral strategies for sustainable growth and development.

The Mexican experience from 1982 to 1999 is illustrative and has three well defined economic stages.

The net capital export stage (1982–88) described as the lost decade of zero economic growth and the net capital import stage (1989–99) made up of two periods, the first from 1988 to 1994 under a quasi-fixed exchange rate regime (with the exchange rate serving as an anti-inflationary anchor) and the second from 1995 to 1999 with a floating exchange rate.

Growth in this second period of net capital import (1989–99) has been unstable, averaging around 3% of GDP i.e., half of the 6% historical annual rate which was the average rate during the sustained import substitution industrialization period of 1945–81.

The globalization of the financial system since the Mexican crisis of 1994, which Michel Camdessus considered as the first financial globalization crisis of the twenty-first century, has produced recurrent international financial crises since the tequila effect of 1994–95 to the dragon effect in 1997–98, to the crisis in Russia in 1998 and later on to Brazilian crisis in 1999, leading to a consensus in the international community that stability for the international financial system (IFS) is not in sight and that new approaches must be sought.

In this context the first element that characterizes the nature of the globalization of the IFS today is that it generates foreign shocks which hit the emerging market economies and produce globalization-induced contagion that affects several countries.

The second factor is the way in which the international financial globalization creates options and imposes limitations on the development strategies of the emerging countries and affects their growth and industrialization policies, employment, income distribution and strategy-driven sustainable development.

There can be no doubt that the end of this millennium features an unfinished transition in the new IFS as well as in the newly liberalized Latin American economies, as well as in other economies around the world. Against this background of an international system in flux it is clear that the analysis of development strategies as they evolve is much more complex than it was before.

2. The recurrent crises of financial globalization: from the tequila to the samba effect

Financial globalization from 1994 to 1999 has been characterized by recurrent and systemic crises which began with the Mexican crisis in 1994-95 and continued with the crisis of the Asian countries in Hong Kong, Thailand, Malaysia and South Korea in 1997-98 and the crisis in the Russia in 1998, and in Brazil in 1999.

The international financial globalization faces the three fundamental problems that any international monetary system has to solve, namely to provide the liquidity needed to finance world trade and finance; secondly to provide an effective and efficient adjustment mechanism for the foreign account imbalances that occur in different countries and thirdly to design a mechanism that assures an equitable distribution of the costs of the adjustments required in a framework of market efficiency and stability.

In this context financial capital markets to date seem far from efficiency in allocating resources and can certainly not be described as having a stable dynamic growth. With an international liquidity of 1.5 trillion dollars being used in daily transactions there would seem in principle that there is no problem in the volume, but rather in the allocation of the international liquidity. The recurrent crises in emerging countries and the contagion to other economies and to the IFS itself restrict capital flows to emerging countries, with a significant drop of net inflows to Latin America in 1999.

Martin Feldstein has articulated another viewpoint, saying that 'An emerging market economy can inoculate itself against future attacks by taking the right measures to boost liquidity: reducing short-term foreign debt, accumulating liquid reserves, and organizing a collateral credit facility' (Feldstein, 1999, p. 102).

Current foreign reserve liquidity requirements go beyond the needs of financing international trade transactions, productive investment and current account deficits as in the past, since the capital account has ceased to be compensatory and is now autonomous, given that financial capital moves on its own and is simply money seeking money. We now observe that excess liquidity because of huge capital inflows or surpluses in the capital account provoke and finance high deficits in current account balances which are unsustainable and trigger financial crises in the emerging countries, with consequent contagion occurring in the IFS.

From 1988 to 1994 Mexico was free of liquidity problems having renegotiated its debt (the Brady Plan) and taken up the 'decatalogue' of the

Washington Consensus in the role of a model country. The country achieved a temporarily effective macroeconomic stabilization by using the exchange rate as an anti-inflationary anchor, reducing inflation from 52% in 1988 to 7% in 1994 and becoming an international example of the three-pillar approach to structural change: reversing protectionism through trade and financial liberalization, deregulating through the opening up of domestic markets and moving away from state interventionism by massive privatization of state-owned enterprises and by reducing public spending. Thus from 1988 to 1994 net inflows of foreign capital mounted to US\$ 100 billion: \$ 72.5 billion in short-term financial capital and \$ 27.5 billion in foreign direct investment, sufficient to finance an historic cumulative deficit of US\$ 107 billion in the current account during that period, with the remaining US\$ 7 billion being financed by reserves from the Bank of Mexico (see Table 16.1).

However for 1994 the foreign deficit in the current account was almost US\$ 30 billion, that is, 7% of GDP. The influx of capital was checked and outflow was avoided by converting government bonds denominated in pesos into dollars for US\$ 30 billion, from treasury certificates to dollar-denominated bonds known as Tesobonds.

At that point foreign capital showed that it was more iatrogenic as a financing mechanism than it was a way of adjusting the external unbalance in the current account. Of the US\$ 107 billion current account deficit, 66 billion was owing to the deficit in the factorial services balances -payment of interest and dividends to financial capital- while the rest was owing to a trade deficit of 41 billion. Thus the medicine aggravated the disease since of each dollar of capital inflows 66 cents flowed back out to service the foreign debt (see Table 16.1).

Table 16.1
EVOLUTION OF EXTERNAL DISEQUILIBRIUM IN MEXICO 1976-94
(millions of US\$)

Partial balances	1976-81	1982-87	1988-94
Trade and non-financial services balance	-13,383	62,599	-41,122
Financial services balance	-28,203	-54,777	-65,969
Current account balance	-41,586	7,821	-107,090
Capital account balance	44,090	-370	100,451
Net reserve change	-2,504	-7,451	6,639
Capital account and reserves balance	41,586	7,821	107,090

Source: Bank of Mexico.

The adjustment mechanism of countries' foreign imbalances continues in today's IFS to be incumbent on countries with deficits and traditional orthodox prescriptions for devaluation and deflationary adjustments in fiscal and monetary policy, whether or not the problem is caused by an overvaluation in the exchange rate as in the case of Mexico, by a fiscal problem as in Brazil or by excess indebtedness assumed by business as in the case of South Korea. The prescription is the same in any case, consisting of anti-growth adjustment policies.

However the Mexican financial crisis of 1994 was certainly the first financial globalization crisis since the adjustment entailed not only reducing the current account deficit by US\$ 30 billion, but also involved almost US\$ 50 billion in payment of the short-term foreign debt, including the Tesobonds. The IMF was unable to provide the liquidity necessary for the adjustment and the Clinton administration provided a bridge loan to rescue Mexico and Wall Street and cover the Tesobonds, which Mexico paid punctually in 1995. For the United States this was one of the most profitable loans, as Treasury Secretary Rubin expressed.

In Martin Feldstein's view, a preventive solution for Mexico in 1999 was to increase its foreign exchange liquidity by doubling its reserves:

Mexico was paying then an 11% interest rate on a 20 year bond, six percentage points more than it would earn on an investment in U.S. Treasury bills. That spread of six percentage points means that an addition of \$30 billion which would double its current reserves would cost Mexico \$1.8 billion a year: nearly half of one percent of its GDP. Although this price may seem high, it must be compared to the potential losses arising from a currency crisis. (see Feldstein, 1999, p. 104)

The Mexican adjustment programme in 1994-95 involved a maxi-devaluation of 100% with the adjustment of the exchange rate from 3.5 to 7 pesos per dollar and a recessionary adjustment of -7.7% of GDP and an inflation of 52% to eliminate the current account balance deficit of US\$ 30 billion, while still obtaining a US\$ 50 billion short-term credit for the payment of the Tesobonds and the banks' short-term foreign debt. In this manner it began the tequila effect in Wall Street and in the rest of the emerging countries. If Mexico had fail to pay its Tesobonds and had failed to make an effective and rapid adjustment there could have been a contagion to the rest of the region and to the IFS, as it occurred in the debt crisis of 1982.

In this scenario the IMF showed its limitations in dealing with the new financial crisis, as the United States had to come to the rescue with a US\$ 20 billion loan. The IMF was able to contribute only with an additional US\$ 17 billion. Camdessus suggested in 1995 that a monitoring and alarm system should be put in place to prevent this type of crisis and contagion in the new

era of financial globalization. Nevertheless from 1994 to the present the IMF monitoring and alarm system has not been put in place or if it does exist it did not work out, since the tequila effect gave way to the Asian crises and its widespread contagion.

The IFS lacks preventive adjustment mechanisms to protect against this type of phenomenon which we could now call recurrent crises in the IFS as a result of financial globalization and electronic money carrying the virus of speculation. The IMF has recently suggested the creation of a preventive new anti-crisis line of credit.

The Russian economic crisis in 1998 also entailed a change from the Mexican crisis of 1994. Not only there was a financial rescue, but costs were shared. A moratorium on payments was declared and government bonds were converted to a five-year term and adjusted to a 7 cents of a dollar value affecting and concerning the international financial community and Wall Street because of the sharing of the cost of the adjustment.

The last crisis in Brazil is also instructive. It not only again showed the limits of the support for adjustment available through the IMF and the limits of a traditional monetary and fiscal policy of contraction of aggregate demand and devaluation, but it also made clear again that it was necessary to act fast to prevent the contagion of the crisis to other countries. Thus in March of 1999 the Real traded at 2.20 to the dollar which represented a 100% devaluation in relation to 1998 and the mechanism to prevent the contagion was an alarm sent out by Undersecretary of the Treasury of the United States Lawrence Summers to the Mexican and Argentine governments, suggesting that they take the traditional medicines of macroeconomic and fiscal adjustment. It was shown up again the inadequacy of the market as a mechanism for achieving automatic adjustments in the presence of disturbances and imbalances in the IFS.

In other words what has become clear in today's IFS is that a process of recurrent systemic tensions owing to financial globalization has begun, and it is evident the need to establish a new architecture in the system. In this context the IMF has been passed by as an institution for providing adjustment mechanisms and schemes to prevent recurrent crises, as well as effective lower-cost correctives for debtors and creditors. Today more than ever stability in the international financial system requires an IMF with new approaches and programs.

The questions that now arise are: Why the globalization of the IFS tends to generate recurrent crises? and why the mechanism of market price signals does not generate an automatic adjustment and leads the global financial market to equilibrium? Two basic reasons stand out:

- Money now has a new function in addition to its traditional roles of being an accounting unit, medium of exchange, and depositary of value; electronic money offers the function of *merchandise*, rented by minutes, seconds and hours to the most favorable international bidder and it can be transferred very fast from one market to another at whatever moment lenders find appropriate, whether their expectations are rational or irrational. In other words hot electronic money, money seeking only money without taking the route of a trade transaction or productive investment is highly volatile and has a speculative nature that negatively affects the receiving country and the rest of the IFS.
- The other problem is that the international electronic money market does not tend to equilibrium because the price mechanism does not work with the rationality that we have come to expect in traditional markets. A high interest rate that can mean high profitability for investment projects and that can move funds from Wall Street and financial agents around the world to certain emerging countries can also mean high risk, so that the flow of capital, which should be checked by the indicator of market prices -when the interest rate is high because of high risk- it can be seen as highly profitable, and therefore the market does not move to equilibrium. There are obviously information problems, but the difficulties go far beyond this. Uncertainty and risk about the future cannot be predicted probabilistically when the future is unknown; there is a lack of knowledge about the new operation of the international monetary system and the change is discontinuous, given the shift from the *ceteris paribus* world of the 1960s to the *mutatis mutandis* world of the 1990s. The reality of globalization and interdependence, from the production site through the global factory system in trade, with regional agreements such as NAFTA, Mercosur, etc. and with globalization in the financial markets, via electronic money with the revolution in communications, with satellite systems, the internet, etc. calls for a more systemic approach to understanding the world of globalization and its impact on the economies, not only of emerging countries but also of industrialized nations. It also requires a systemic approach to dealing with the functioning of the system as a whole.

The problem derives from the fact that in the 1960s under the Bretton Woods system the balance of payments capital account was compensatory i.e. it was primarily used to finance capital account deficits, while in the 1990s the capital account is autonomous and besides financing needs for trade or investment it has its own life due to the presence of hot electronic money. From 1990 to 1996 private capital flows to emerging market economies increased by more than a factor of six to reach a record US\$ 256 billion in 1997. By the end of that year financial portfolio capital was at half that level, and this in turn provoked a destabilizing phenomenon.

On the other hand excess flow of short-term financial capital generates excess supply in the foreign currency markets of emerging economies and leads to the appreciation of their real exchange rates, with consequent increases in current account deficits, creating in turn a greater need for financial capital, which calls for raising interest rates, given the international competition for capital, triggering a iatrogenic effect of foreign capital and making emerging market economies vulnerable on the foreign currency front.

In this context globalization of the IFS and capital flows to emerging countries generate options and limitations. They create vulnerabilities to shocks and contagion effects from recurrent crises in the system. Views on how to deal with capital flows range from controlling currency exchange (Paul Krugman and the Malaysia experience) to regulating capital (Tobin, Stiglitz, Ffrench-Davis), to raising transaction costs (the Tobin tax, legal reserve requirements of 30% on foreign capital for six months without interest) and to providing absolute freedom for capital to move where it wants to (Dornbush).

From another point of view there are writers such as Paul Davidson who show that emerging countries have no road to development in the absence of a new IFS based on an international union for settlements (Davidson, 1998), and Martin Feldstein, who takes the tack that rather than wait for a new international financial architecture or new IMF programs the emerging countries themselves should seek their own path and develop their own strategies to deal with the crises of financial globalization and he points out that:

Like death and taxes, international economic crises cannot be avoided. They will continue to occur as they have occurred in past centuries. Unfortunately there is no international '911' that emerging markets can dial when facing economic collapse. Neither the International Monetary Fund nor a new global financial architecture will make the world less dangerous. Instead, countries that want to avoid a devastating rerun of the 1997-98 crisis must learn to protect themselves and self-protection requires more than avoiding bad policies that make a currency crisis inevitable, for the threat of contagion makes even the virtuous vulnerable to currency runs.

Liquidity is the key to financial self-help. A country that has substantial international liquidity, large foreign currency reserves and a ready source of foreign currency loans is less likely to be the object of a currency attack. Substantial liquidity also enables a country already under speculative siege to better defend itself and make more orderly financial adjustments. The challenge is to find ways to increase liquidity at a reasonable cost (Feldstein, 1999, p. 93).

The challenge of building and designing a global architecture for the financial system is similar to the already successfully-met challenge of information globalization, and it is instructive to look at the parallels between these two areas.

In the 1990s the globalization of information via telecommunications and the internet is an established reality. Information has ceased being a scarce good and is moving at the speed of light. Any player that wants to be part of the new era and has access to the information economy must undergo integration into today's globalized world of information. Autarchy and isolation lead to stagnation and mean falling behind in terms of information. However it is generally acknowledged that opening the doors to the information world without restriction is not a desirable approach, since computer viruses can not only destabilize systems but they can also destroy software and even affect hardware.

Thus filters have been created with special programs to detect harmful information and set off alarms to system operators to make it possible to reject information or clean and filter it before allowing it in, preventing contagion in the system.

The art of managing financial globalization as it is in managing information means dealing with how to prevent speculative capital from coming into emerging countries' economic/financial systems, while at the same time it is permitted the flow of long-term capital. It is a task that requires mechanisms to block and filter speculative, volatile short-term capital.

Exchange controls are not an efficient mechanism to prevent negative impact on flows of speculative and volatile capital because they block all information rather than discriminating between good and bad. In other words all transactions related to trade, productive investment and long-term capital are subject to controls under such a system, making it highly inefficient. A totally free system allowing electronic speculative money to pass, as has been seen in the recurrent crises from the tequila to the samba effect is not only destabilizing to emerging economies, but it also disseminates the contagion to the rest of the IFS.

So we may say that the challenge of the new global financial architecture is to design mechanisms that will permit long-term capital flows, using special signals to alert the system before speculative money is allowed in. This mechanism permits rejection and, if necessary, filtering, as in the Chilean model, so that volatile capital is prevented to enter into the country.

Under this approach Stiglitz believes that the imperfection and instability of today's global financial market can be at least partially remedied in the following ways:

- With *more information and transparency*. For example the Mexican crisis began in part when investors discovered that reserve levels were less than thought, and short-term debt was greater. This kind of change, however, only produces partial improvement, since better information, like a map, provides useful information on the road to be taken on the surrounding terrain but can hardly rescue the traveller if a hurricane hits.
- 'Domestic reforms can create a stronger and more transparent financial market, more transparent corporate governance systems, and a less error-prone macroeconomic policy' (Stiglitz, 1998b, emphasis added).
- In the last analysis, however, as Stiglitz says, investors in emerging markets and the international financial community in general need to consider a third response: *regulation of international capital flows*. This means eliminating prejudices against intervention since rescues of countries' economies and banking systems are obviously interventions made necessary by failures of the market.

In the Mexican case the IMF-US rescue was a US\$ 50 billion operation, and the Bank Savings Protection Fund rescue of the Mexican banking system involved more than 13% of GDP (US\$ 60 billion), while the Asian case involved US\$ 110 billion. 'Now is the time, before the next crisis, to take an orderly approach to designing procedures to put the economy in order, which will provide better incentives and a more equitable absorption of costs' (Stiglitz, 1998b).

In this manner we can say that a new international monetary and financial system is needed, and that today, more than ever, the IMF is necessary but it has to be a new IMF which as an international institution establishes and ensures observation of the new 'rules of the game' that make it possible to differentiate between foreign direct investment capital and hot electronic capital that carries speculation.

On the other hand it should be noted in this context that we have yet to witness a shock between the dollar and the euro, and as Fred Bergsten has pointed out:

America's net foreign debt now approaches US\$ 2 trillion. As soon as the European Central Bank establishes its credibility the euro will become a global financial asset and this will produce a portfolio diversification from dollars into euros by private investors and central banks that could ultimately reach US\$500 billion to US\$1 trillion. The short-term problem is that the shift from dollars to euros could lead to a broad swing in the dollar-euro exchange rate (Bergsten, 1999, p. 27).

In summary, a more thorough analysis is required to assess the recurrent crises attendant on financial globalization in order to prescribe appropriate policy for the new century. There is wide agreement on the need for a new international financial system and a new IMF to make the global economy of

the twenty-first century viable. For the time being it is important to learn from the errors of the past and draw from them, and as Garten has pointed out, there are several key areas that have to be carefully taken into consideration and Wall Street and Washington do seem able to agree on them:

1. The financial system is not stable.
2. The implications of what started in Thailand were badly underestimated.
3. Lenders and investors had wrong expectations.
4. The nature of the contagion effect of the crisis was not well understood.
5. The initial diagnosis missed the mark.
6. All risk management systems failed.
7. New financial players changed the rules of the game.
8. Local policies are crucial.
9. Transparency, information disclosure and adequate financial regulation were sorely lacking.
10. The IMF was and remains to be crucial to economic stabilization and recovery. (Garten, 1999).

Emerging countries such as Mexico face some policy choices, with its associated costs and benefits which are ultimately ancillary and will be viable or not depending on global as well as on national realities:

- To move toward a *new architecture* for the international financial and monetary system is certainly one of the basic tasks to be accomplished, not only for the G-7, but for all countries, the emerging economies among them. This requires:
 1. A new IMF that not only has more capital but that has new policy approaches and provides efficiently programs for economies which become cases of contagion in international financial crises. Recent IMF contingency credit lines allow Mexico the access to US\$ 4.2 billion over 17 months with repayment from 2003 to 2005 (see Table 16.2).
 2. James Tobin has suggested eliminating volatility and speculation due to movements of short-term capital by means of the now well known Tobin tax, consisting of a universal tax to be implemented by all countries which amounts to a 2% tax to all economic and financial transactions. This would require international agreement, whence arises the difficulty of implementing it.
 3. Nevertheless while a new international architecture is being constructed at the IMF involving new approaches and programs the emerging countries will have to continue to deal with the recurrent crises of the financial globalization. It will be necessary for them as well as for others not only to have consistent macroeconomic policies, but also to develop solid, efficient and well supervised banking systems, and to keep a handle on proper levels of foreign deficits and provide for healthy financing with long-term capital. It will be necessary to seek self-help mechanisms such as the following:

Table 16.2
**ANTI CRISIS COLLATERAL AND CONTINGENT
 CREDIT PROGRAM, 1999-2005**

(millions of US\$)

IMF	4,200	Length of operation: 17 months To be paid between the years 2003 and 2005
World Bank	5,200	For the 1999-2001 period. Support to social programs and to preserve economic Stability
IDB	3,500	For the 1999-2001 period. To be used in programs that will support the development of state and municipal infrastructure.
US Ex-Im Bank	4,000	To finance imports from the USA
US and Canada Central Banks	6,800	Resources agreed on NAFTA negotiations, as financial Assistance
Total	23,700	

- There must be *mechanisms* to regulate short-term speculative financial capital such as policies to raise transaction costs to penalize and check volatile short-term capital while allowing long-term capital to flow. The legal reserves system in Chile is the method that has proved in practice the best implementation of this policy, since it sets a flexible minimum reserve ratio for all financial capital coming into the country. If the capital remains in the country for more than a year, the total original amount is returned to the investor, and if the capital remains for less than a year, the country keeps the given percentage of it for the minimum period. This has permitted Chile to increase long-term foreign investment and minimize short-term speculative capital inflows.
- *New strategies* for sustained growth must be developed to make it possible again for industrialization to be the engine of growth, complemented by other policies, producing a greater domestic capacity to generate foreign reserves to finance necessary investment, where foreign savings are only supplementary to domestic savings. Hence the importance of developing and implementing an active and integrated policy governing foreign trade in goods and services for the coming decades. Mexico has ample export potential not only for goods but also for services such as tourism, which could certainly become several times greater than its volume of oil exports.

- Measures that increase available *foreign reserve liquidity* by reducing short-term foreign debt, allowing for the accumulation of liquid reserves as well as the organization of collateral lines of credit. Along these lines Mexico recently implemented its Program of Financial Strengthening for the 1999–2000 period for almost US\$ 24 billion, seeking to improve its foreign reserve liquidity. It includes lines of refinancing plus extraordinary funds consisting of new collateral lines of credit to be available in case of problems arising from foreign crises. This made it possible to create a climate of greater confidence as the political/electoral process of the year 2000 approached.
- Mexico's program of financial armouring could be considered the first step toward a new architecture in the IFS, a process expanded and reinforced by various economic policy measures aimed at creating a system of economic armour. These measures are the following:
 - A flexible exchange rate policy.
 - Reduction of short-term debt.
 - Increase in the domestic savings rate.
 - Maintenance of a current account deficit in the vicinity of 3%, financed primarily with foreign direct investment and long-term capital.
 - Restrictive monetary policy.

The reserve level of almost US\$ 30 billion in July 1999 and the new program of collateral and contingent lines of credit of US\$ 23.7 billion ultimately provide reserves of more than US\$ 50 billion and enhance liquidity. This is Mexico's anti-crisis economic-financial armour for the 1999–2000 period. Despite this advance, the challenge of building a new architecture for the international financial system remains, since 'developing countries are more vulnerable than ever to the unpredictable movements of international capital. Small economies are like rowboats on the open sea. Well-managed though they be, the possibility of a big wave carrying them away remains significant' (Stiglitz, 1998b).

3. Development strategy: from the Washington Consensus to the Latin American Consensus

The origins of the current financial crises lie elsewhere and their solutions will not be found in the Washington consensus

The so-called 'Washington consensus' of US economic officials, the International Monetary Fund (IMF), and the World Bank was formed in the midst of these serious problems. Now is a good time to re-examine this consensus...

(Joseph Stiglitz, 1998a)

In the aftermath of the debt crisis, flows of foreign capital to Latin America and emerging countries began again in 1989. However given the privatization of these flows this meant complying with an implicit program of conditions generally accepted by the international community in Washington and by Latin American governments, summarized in what John Williamson (1998) called the Washington Consensus. In light of the experience of the 1990s in Latin America, with slow growth and with the journey toward becoming competitive economies still to be completed, Williamson suggested the need of a new consensus (see Table 16.3).

The Washington Consensus contains a pair of policy packages, namely:

- The *macroeconomic stabilization and structural change policies* that we have referred to before, entailing a move away from protectionism through liberalization of trade, finance and foreign investment; deregulation through liberalization of domestic markets and protection of property rights and significant privatization of public enterprises along with reduction of public spending.
- And an *implicit development policy*, which may be summarized as follows: countries should try to have a free market economy, open and privatized, in a context of macroeconomic stability, a necessary and sufficient condition to guarantee efficient and competitive markets through the invisible hand of the international free market in order to achieve sustained economic growth with full employment (see Figure 16.1).

Table 16.3
THE NEW AND OLD WASHINGTON CONSENSUS

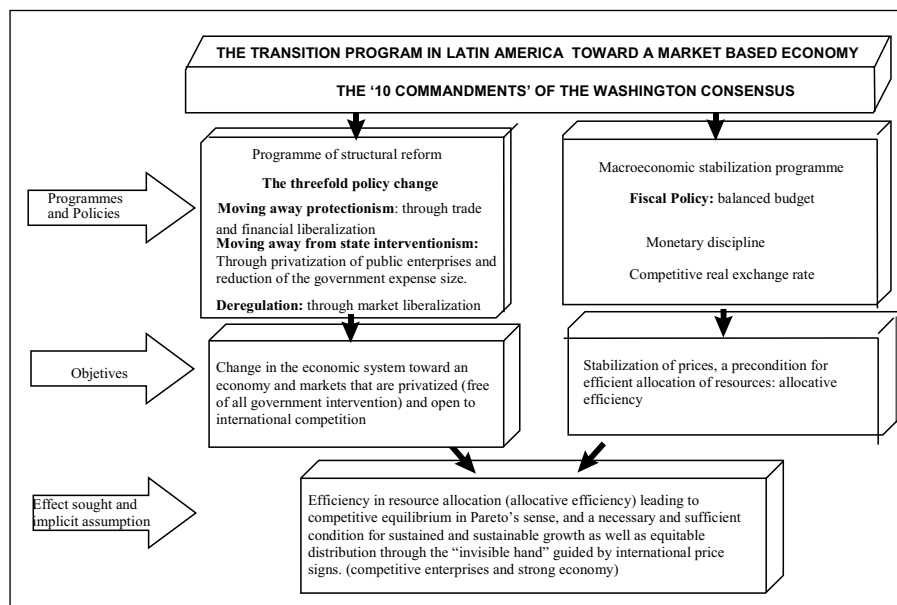
The Washington Consensus	The New Washington Consensus
<p><i>Macroeconomic adjustment and stabilization policies</i></p> <ol style="list-style-type: none"> 1. Tax reform 2. Fiscal discipline 3. Monetary discipline 4. Exchange rate discipline: real exchange rate <p><i>Three-pronged policy of "structural change"</i></p> <p>Moving away from protectionism by:</p> <ol style="list-style-type: none"> 5. Trade liberalization 6. Financial liberalization 7. Liberalization of foreign investment <p>Deregulation by:</p> <ol style="list-style-type: none"> 8. Liberalization of domestic markets and property rights <p>Moving away from state interventionism by:</p> <ol style="list-style-type: none"> 9. Privatization of public enterprises 10. Size reduction of the government 	<ul style="list-style-type: none"> • Increased saving through fiscal discipline. • Reinvestment of public spending in well-designed social programmes. • Reform of the tax system, introducing, among other elements, a land-use tax that takes ecological considerations into account. • Consolidation of banking supervision. • Maintenance of competitive exchange rates, bringing back floating exchange rates or using them as nominal anchors. • Continued liberalization of intra-regional trade. • Creation of a competitive market economy through privatization and liberalization, including the labour market. • Redefinition of and provision of access to property rights for all society. • Creation of strategic institutions such as autonomous central banks, strong budget commissions, an independent judiciary that cannot be corrupted and entities to support activities that promote productivity. • Increased educational spending, especially at the primary and secondary levels.

Source: Williamson (1998).

Neither in practice nor yet in theory, given the failures, imperfections and limits of the market in developing countries can it be guaranteed that free, open and privatized markets will lead to efficient and competitive markets and to an optimal allocation of resources, although it has been evident that the market is the best method for promoting efficient allocation of resources, nor is it a forgone conclusion, even if this is achieved, that a new model of capital accumulation, saving and technological progress will arise to ensure sustained growth with full employment and patterns of equitable distribution in the developing economies.

The problem of the development strategy implicit in the Washington Consensus is not due only to the limitations that financial globalization has placed on macroeconomic stabilization and to the limits of reform in the three areas of structural change for, as Stiglitz has pointed out, the invisible hand is not seen, not because it is invisible, but because it has never existed.

Figure 16.1



Source: Villarreal (1998, p. 32).

The experience of Latin America and the Mexican experience in the 1990s as a model country for the implementation of the Washington Consensus show that regardless of implementation problems, though an open and privatized market left to the free forces of the international market may generate better allocation of resources in the economy, it does not guarantee a new model of capital accumulation, saving and technological progress or innovation in production, creation of full employment or in ensuring equitable distribution of income, nor does it guarantee a new model of liberalized export-oriented industrialization that is competitive and can be sustained as the engine of growth and development for the countries now referred to as emerging countries.

In other words a problem in dealing with a development strategy for Latin America is a conceptual one: what has been, is today and can serve in the future as an integral development strategy that is consistent and can be viable in the context of the new reality of global capitalism?

The new Washington Consensus summarized by Williamson (see Table 16.3) still lacks an integral development strategy, i.e. a model of capital accumulation with a national system of innovation and a new strategy and policy for industrialization since it emphasizes in the list of policies the traditional ones of the old Washington Consensus of privatization and liberalization-including the labour market in them-to create an efficient and competitive market economy, and it proposes new lines of policy in areas where serious lacks are evident such as the creation of strategic institutions, the consolidation of banking supervision and the implementation of policies directly related to growth, increased spending for education, higher rates of savings and better income distribution through reinvestment of public spending in social programs to address the social deficit that has been growing in the last decades.

It is important to point out that since the foreign debt crisis of 1982 new integral development theories or approaches for Latin America have not been developed and economic policy has concentrated primarily on macroeconomic stabilization strategies and the three so-called structural change areas, through liberalization and deregulation of markets and the privatization of the economy, which are not related to the original concept of changing the economic structure of Latin America and which have more to do with changes in the structure to have a more productive supply and its implications for growth and distribution. It is in this context that the various ECLAC studies on transformation of productive structures and the attainment of a more equitable distribution of income have been carried out.

The region's evaluation of economic and social performance points to major remaining challenges, as reported by IDB (1997):

Latin America's economic and social performance during the nineties has not been satisfactory. While economic growth has recovered, it has not returned to the rates that were common in the region in the sixties and seventies, and it is far less than the sustained rates that have been typical of the Southeast Asian countries. In 1996, eight out of every 100 Latin Americans willing to work had no job; at the end of the eighties, unemployment rates had been lower, between 5% and 6%. Latin America is the area of the world where income distribution is worst, and that situation has not improved in the nineties. Nor has the number of poor people declined from the unprecedented level of close to 150 million that it reached at the beginning of the decade of the 1990s. The insufficient economic and social progress of Latin American countries stands in contrast to the magnitude of the changes that have taken place in their economic policies.

Because of the theoretical and practical limitations of the Washington Consensus as an integral development strategy for Latin America, various studies (World Bank, IDB, etc.) have taken up the historical model of the

Southeast Asian countries, which have been successful in generating high levels of sustained growth and in creating productive jobs and a more equitable income distributive patterns than in Latin America, while offering a model of open and competitive industrialization based on manufacturing exports. Of note here are three basic policies that have led to success in Southeast Asia: good management and handling on the macroeconomic front, a policy of savings incentives and trade and industrial policies that promote manufacturing exports, which facilitated a process of rapid accumulation of physical and human capital while increasing productivity in general, as sources of economic growth. The focus is on the role of the state in encouraging such change, with market-friendly rather than market-hostile policies, i.e. with policies that complement the market rather than replace it as the primary mechanism for the allocation of resources.

As suggested in 1998 by Joseph Stiglitz, then Vice-President and Chief Economist of the World Bank:

The so-called Washington Consensus of US economic officials, the International Monetary Fund (IMF), and the World Bank was formed in the midst of serious problems. Now is a good time to re-examine this consensus since The Washington Consensus does not offer answers to every important question in development.

One principle that emerges from the idea of whatever a new Washington Consensus is, is that if policies are to be sustainable, developing countries must claim ownership of them ...

A second principle of the emerging consensus is that a greater degree of humility is called for, acknowledgment of the fact that we do not have all of the answers. Continued research and discussion, not just between the World Bank and the International Monetary Fund but throughout the world is essential if we are to better understand how to achieve our many goals (Stiglitz, 1998a).

This scenario calls not only for fine-tuning adjustments in the Washington Consensus policy package, or for putting together a new Washington Consensus, but for putting forward a new integral development strategy that aims not only at privatized economies, free and open markets and macroeconomic stability, but also at a new model of sustained and sustainable growth with productive employment and more equitable distributive patterns, as well as a three-dimensional strategy of industrialization (leverage via exports, competitive import substitution and the endogenous pivot) as the driving force for growth and the articulation of chains of production, making it possible to recover and surpass the historical rate of sustained growth that has already been achieved in our countries in the past (Villarreal, 1998).

With hindsight and a vision of the future, as well as the elimination of all 'paradigmatic blindness' *vis-à-vis* extreme poverty and the urgent need to provide hope for a better world for the younger generation, it is necessary today more than ever to build a new Latin American consensus based on an integral development strategy for Latin America in the twenty-first century, taking note of the limitations and options our that countries face with the financial globalization.

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PART III

**STATEMENTS: THE SOCIAL ACTORS
IN THE FACE OF VULNERABILITY**

17. THE RESPONSIBILITY OF FINANCIAL ACTORS

*Angelo Caloia **

There is no sector in which both the amount and the typology of transactions prove to be less suitable for attaining the objectives of efficacy and efficiency as regards the level and quality of the investments than the international finance sector. This is all the more true when the field of observation is characterized by scarcity of resident operators, poor technical preparation, information asymmetries, low level of competition among domestic intermediaries, inadequacy of regulations and economic policies that are far from credible in the presence of unbalances, be they real or a matter of foreign currency. The availability of foreign capital, which in some cases acted as a flywheel for the development of emerging economies, has more frequently transformed them into unsustainable indebtedness and a serious worsening of the economic and social framework.

Following the expansion and integration of the commodity, service, capital and labour markets, the international financial system has undoubtedly achieved a considerable increase of transactions and intermediated volumes (Fazio, 1998; IMF, 1998; Institute of International Finance Inc., 1999), but also had to face a growing volatility and ever-more frequent crises. The pressure on emerging countries for accelerating the process of financial liberalization -the so-called 'Washington consensus'- has certainly led to the opening of these new markets, but has also induced overhasty and not always sustainable changes.

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1. Financial unbalance: historical references

A disorderly macroeconomic/environmental framework, but also the inadequate, irresponsible and even dishonest behaviour of the operators, are the explanations usually adopted for the formation and intensification of international financial unbalances.

In the former case the financial precariousness is said to derive from 'fundamentals' (monetary aggregates, inflation rate, fiscal deficit, public debt, foreign debt) inappropriate for a sustainable and lasting growth. In the absence of credible economic policies, it has been proposed -on the basis of Krugman-type models (Krugman (1988, 1991; Krugman and Miller, 1992)- to intervene by tying the hands of the policy-makers, hooking the national currency to a series of key currencies, strengthening international cooperation, enlarging the autonomy of the persons responsible for monetary policy and setting up external monitoring and control systems. In the 1980s, this was done to face the difficulties of Latin America and some European countries (Italy and France).

But the situation in the 1990s is rather different. Both the Mexican crisis (1994-95) and the Asian one (1997-98), occurred while the 'fundamentals' and the international monetary framework were acceptable, the latter wholly devoid of interest rate tensions comparable to the Volcker shock at the beginning of the 1980s. As compared with the experiences of those years, a far more important and even decisive role in unleashing the crisis was played by the speculative activities of economic operators with immense financial means.¹

On the other hand, the national public powers were almost never prepared to bear the domestic costs -in terms of production and employment- of rigid monetary policies.

Another characteristic feature of the recent international crises is the fact that they are the fruit of an accumulation of tensions in currency, stock exchange and banking sectors. In these situations, paradoxically, it is of little or no importance to comprehend the origin of the unbalance -be it collapse of the exchange rate, stock exchange difficulties owing to foreign portfolio disinvestments, lack of liquidity in the banking system- what really matters is to assess the rapidity and pervasiveness of the process by which the crisis extends to the real sector and its geographic contagion.

Just as in the past, the recent cases of serious financial unbalance highlight the fact that, in the absence of precise conditions, the market mechanism does not succeed in coordinating the decisions of the economic operators in order to ensure an optimal outcome. This seems true the more degraded the context is, the more diverse the countries and the instruments are.

1 See Banca d'Italia (1998a, 1998b).

2. How to achieve (just and sustainable) growth objectives

What, then, can we do? Given the need for controlling decentralized financial activities, it may -first of all- be desirable to establish rules and limits for the activities of the various intermediation bodies to avoid damaging downward competition between the financial centres of the various countries. In particular, it seems necessary to set up appropriate monitoring and control mechanisms, and this notwithstanding the difficulties induced by the presence of different typologies of economic operators, the often enormous size of the intermediated capital, the continuous introduction of technical innovation and the new electronic funds transfer procedures (Caloia, 1998a).

Secondly, 'stable, sound and predictable' monetary, exchange rate and fiscal policies, as well as structural policies must be followed. In this case the protagonists are the national policy-makers, even though the effects of their policies may be partly neutralized by international capital flows. Indeed, capital movements place limits on autonomous variations of interest rates, the possible degrees of liberty -the so-called 'pin pricks' - being bound up with the sophistication of the financial instruments. Nor does the road of financial autarchy seem possible in present-day conditions especially when the international finance is the preferential vehicle of real transactions, of transfers of managerial capacity, of technical progress and organizational transformations, as also of search for new outlet markets.

That is the reason why the last few decades have tended to attribute ever-greater importance to international coordination of economic policies in order to render the individual national policies credible and make it easier to determine the costs and benefits of every intervention. The systemic nature of the coordination (and the necessary control, management and monitoring systems) seem to require international economic institutions different from the present 'directorates' of the more influential industrial countries (e.g. G-7, G-8): given the possible conflicts of interest with the developing countries and the economies in transition, there are strong doubts as to the legitimacy of these bodies managing the world economy.

3. From the action of the policy-makers to the behaviour of the financial operators

So far we have seen the factors that move the action of the public powers and the international institutions in the field of world finance. What has remained excluded is the part played by the financial operators in generating, accentuating and extending the unbalances. Better still: the conceptual patterns underlying the

action and regulation of the activities of individuals assume stereotyped rational behaviours, whereas in actual practice behaviour is often rather different (herd behaviour, behaviour based on fixed computerized rules).

Quite apart from the institutional and legal framework that could be created, there re-emerges the problem of responsibility of the individual economic agents, even though they are strongly influenced by the existing socio-cultural context. From this point of view, an important role has to be played by such bodies extraneous to financial intermediation as trade unions, professional organizations, mass media, churches and cultural organizations, all of which contribute to the foundation of new values. Even more important is the contribution of the academic and research institutions when they succeed in clarifying the technical modalities and the ultimate effects of financial intermediation worldwide.

The identification of the responsible behaviour patterns remains a rather difficult task. The complexity and unpredictability of the international financial game induces the operators to pursue their own survival even to the detriment of the users of their services. It is therefore a very ambitious objective to hope to identify 'virtuous' behaviours with a view to rebalancing seriously distorted situations -or, what would be even more desirable, promoting diversification and growth of the productive structures of the less advanced economies.

4. The other financial actors: economic institutions, supervisory authorities, the private sector

The crisis in Mexico and, more recently, in Southeast Asia, Russia and Brazil, has drawn attention, above all, to the capacity of the supernational economic organizations to forestall and manage international financial tensions.

From the meetings of the G-7 and the G-22 held in April 1998 there thus came clear indications for a greater and more coordinated participation of the debtor countries, the international financial institutions and the private creditors in the prevention and management of crises (Banca d'Italia, 1998c). There was also a pressing demand for greater disclosure of macroeconomic information: the FMI member states -so it was said- should publish the data relating to official reserves, short-term indebtedness and the stability indicators of the national financial system. Lastly, these meetings correctly suggested the adoption of principles in line with those proposed by the Basle Committee on the adequacy of the assets of banks, the valuation of credits and reserves, risk and corporate governance. National regulations were urged to seek a greater degree of homogeneity concerning anti-trust safeguards,

insider trading and cooperation between supervisory authorities in exchanging information and reports.

The supernational economic organizations were also asked to carry out, over and above their traditional functions of managing the exchange rate regime and granting financial assistance to the emerging countries, such functions as multilateral supervision of macroeconomic policies, of the orderly performance of international transactions and of the payment system, and technical assistance for the developing countries.

The private sector (merchant banks, financial and insurance companies) should bear part of the cost of the crises, following common principles to protect creditors in all the FMI member countries, harmonize the bankruptcy legislation, introduce debt instruments to facilitate 'amicable' composition of illiquidity situations with the assistance of bodies like the IMF (Giannini, 1998).

5. Unacceptable behaviour: an overview

But, quite apart from these intentions to reform the institutions and the national and international economic policies, there still remains the problem of the negative behaviour of the financial operators, especially when market competition is lacking and the macroeconomic fundamentals are off-line.

The recycling of dirty money threatens to pollute all international financial relations. Recent years seem to have conferred new vigour upon organized crime, not least on account of the collapse of the political regimes in Eastern Europe. The phenomenon, which avails itself of the 'white collars' only at the end of a long chain of crimes, is the last link of the chain, so that there is need to trace things back to the original criminal phenomenon (gambling, dope, prostitution, contraband, kidnapping, corruption, etc.).

Equally criminal and only apparently less laden with consequences are fund transfers that do not respect foreign currency regulations and are made for the sole purpose of achieving speculative gains from a probable depreciation of the exchange rate or from fiscal advantages. For reasons of opportunity, unfortunately, the countries struck by such capital flights are often obliged to facilitate its return (once the depreciation has taken place or the political instability risks have been overcome) by granting complete juridical and often also fiscal impunity to the exporters.

As far as this matter is concerned, one cannot therefore but pin one's faith on an international jurisdiction capable of discerning these capital movements according to duration, source and type of investment, more or less on the lines of what is currently being discussed.

Somewhat subtler, but no less unacceptable, are the forms of behaviour based on the concepts proposed by very modern financial theory: moral hazard,² adverse selection, information asymmetry, credit rationing, reporting mechanism and the bailout phenomenon.

The international banks are charged with drawing advantage from a degraded international financial market and the situation of weakness of the contracting parties: in this case it should be given the possibility of denouncing before appropriate international bodies loan contracts that, given their complexity and degree of innovation, could get out of hand for borrowers accustomed to obtaining resources from public institutions in conditions of stability. Short maturities, and variable rates and indebtedness in strong currencies, tend to aggravate the foreign debt burden as soon as the conditions of world finance deteriorate or the national currency suffers a significant depreciation. Above all, the lending banks (with the exception of the World Bank) do not pay sufficient attention to the fact that the capacity of repaying foreign loans depends not only on the return of individual projects, but also on a country's capacity of transforming domestic resources into foreign currency (by expanding exports or, more rarely, cutting down imports). Thus foreign loans often end up financing deficits in the balance of payments; this not least due to the fact that commercial banks are quite incapable of monitoring the use of the loaned funds, lacking the necessary information, qualified personnel and appropriate standard procedures.

After the first oil shock, the international loan market assumed a worse feature by tolerating the fitting of banks of doubtful capacity that sought refuge in the practice of syndicated loans, as if shared misfortune could sweeten a bitter pill.

Notwithstanding this rather gloomy general picture, the action of the public powers of the lending countries was -and substantially still is- noteworthy only by its absence, and sometimes even to the point of conniving, it either sees the financing of high-risk projects as a flywheel for the country's exports or in the sense of bearing (and here we have the bailout phenomenon) at least a part of the restructuring costs made necessary by the foreseeable international payments crises of the more disaster-stricken debtor countries.

The phenomena undermining the efficacy of the financial markets are emphasized in the following paragraphs.

Thus, the different information about the quality of the products assures that bad products are being negotiated at the same price as good ones, which are therefore bound to disappear. Adverse selection can make its appearance in the financial markets because some of the participants have information

2 On 'moral hazard' see Giannini (1998); Caloia (1998b).

advantages on account of their closer links with a given company ('insiders') or comparative advantages in the collection of information (financial analysts). For example, since the purchase prices of the securities reflect the average quality of the businesses that issue them, the managers of high-quality companies realize that they are underestimated and refrain from offering them. The low-quality companies, on the other hand, will sell them in excessive quantities.

The final result is the rationing of projects with a positive net present value. Moral hazard is present when, seeing that a certain risk is covered by private insurance counterparts or government or supranational bodies, the financial agent becomes insensitive to employing funds in risky activities. Especially when the countries at risk are of considerable size and play a dominant part within a given geographical region, there exists the danger of stimulating inefficient behaviour if the bailout becomes a matter of course or is granted too readily.

The availability of credit (rather than its cost) plays a strategic part, especially as regards the amount and the quality of the investments. But very substantial rationing is due to the imperfection of the financial markets -e.g. usury phenomena, strong oligopolistic positions, 'ceilings' fixed by professional organizations or public powers.

Loan demand is not inversely proportional to the rate of interest (as expected by economic theory) because borrowers are not always conscious of the greater costs caused by an upturn of interest rates, and lenders place a quantitative limit on their loans to short-term-prone entrepreneurs. Credit rationing is very often the result of 'moral hazard' behaviour and adverse selection processes. Given conditions of low sensitivity to risk, the search for higher profits will inevitably lead to the financing of projects with a high degree of uncertainty.

Lastly, unacceptable are also all actions taken to modify in one's own favour the legislative and regulatory framework of the financial sector, especially in view of the indirect and long-term effects that may be generated. Not only does the financial sector perform an important function in the implementation of monetary and exchange rate policy, but it can use lobbying (Caloia, 1998b) for the purpose of pushing sectoral legislation to obtain protection, subsidies and tax reductions.

6. Conclusions

As a result of developments in recent decades, international finance has now assumed characteristics that are historically wholly new and only partly correlated with the substantial growth of the 'real' economy. These

tumultuous dynamics seem to be the principal cause of the substantial market volatility, instability and frequency of international financial crises. This makes it desirable and, indeed, necessary to define a 'new architecture' of the international financial system and numerous and authoritative proposals regarding this matter have been put forward, not least as a result of work undertaken by major institutions.

The pillars on which it seems desirable to found the new order of world finance can be epitomized into three main lines of intervention.

First, it seems desirable to usher in an overall reform of the multilateral bodies, which should henceforth have greater political weight -and therefore also greater capacity of governing the markets- through the involvement of the 'weak' countries, thereby coordinating national policy-makers and the international institution as regards both their preventive regulatory action and their interventions in case of crises.

Further, endeavours should be made to rationalize the existing bodies to enhance their efficiency and share the information and know-how resources for their common benefit.

Unlike what happened in the past, the new market governance must not in any way justify inefficient behaviour or moral hazard and even outright illegality. Private financial operators rather have to be rendered responsible and involved in the prevention and management of crises, and must assume in full the risks of the evaluation of creditworthiness.

A second fundamental aspect is the further spread of the practices already adopted by the main industrialized countries to assure supervision of the banking and financial sector -transparency of company information, standardization of balance sheets and accountancy criteria, corporate governance, etc. Attention must also be paid to constant and purposeful updating of standards in the supervision of financial innovation, which is often so rapid as to render the existing regulations obsolete and inadequate. In this field, once again, a fundamental aspect is represented by coordination and cooperation to ensure that international standards will be appropriately aligned with the regulations and practices adopted by the individual countries, without sacrificing the necessary rigour (Basle Committee and Technical Committee of the IOSCO, 1996; Basle Committee on Banking Supervision, 1998a, 1998b; Padoa Schioppa, 1998).

This need, clearly felt by all international authorities, underlies the proposal to set up a 'Forum for Financial Stability' approved by the G-7 in February 1999 (G-7, 1999; Tietmeyer, 1999). The Forum should enable national and international authorities (with the involvement of developing countries), multilateral bodies (IMF and World Bank), supervisory organs (including the Basle Committee, IOSCO and IAS) and expert groups to coordinate their

respective responsibilities more effectively. A shortcoming of the proposal is however constituted by the fact that it was proposed by the main industrial countries, a top-down initiative that might be felt as a defence of the interests of these countries.

Thirdly and lastly, the recent financial crisis invites us to reflect about the destabilizing power of short-term capital flows and to consider the possibility of administrative measures to bridle such movements or even subjecting these transactions to taxation, somewhat in the manner of the 'Tobin tax'. However, given the difficulties experienced in applying unilateral measures to discourage short-term capital flows, often ineffective when attempted, efforts should also be made to find ways and means of promoting forms of finance that do not create debts, including foreign direct investments and equity investments (Caloia, 1998a).

This search for adequate solutions is not to be understood as 'against' the market. Quite the contrary, it is precisely the introduction of equitable and transparent 'rules of the game' at the international level that enables the market to fully perform its allocation capacities and to stabilize the world economy along a development path that is both sustainable and socially and morally acceptable.

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18. INTERNATIONAL FINANCIAL FLOWS: A LABOUR POINT OF VIEW

*Luis Anderson **

Imagine that most people are wondering and deeply concerned about whether the new century is going to begin with the first global depression of the age of globalization. As we approach the second anniversary of the beginning of the Asian economic and financial crisis, we see that it has become global. During much of the 1990s, Eastern Asia was the engine for world growth. In 1996 it generated one-quarter of world trade.

Owing to the reverses that some of these economies have experienced and to the fact that imports have fallen by one-third, prices of commodities are falling, with adverse effects on commodities exports for the majority of developing countries. Prices of commodities other than oil have dropped 10% and continue their downward trend. Oil prices have been the most seriously affected, falling almost to their pre-1974 oil crisis level.

Many international businesses are making downward revisions in projected earnings and are putting off investment. Growth in the industrialized countries is falling off. The price paid for bad management of the globalization process is the loss of millions of jobs by the working class and

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acute intensification of world poverty. The crisis of the Mexican peso in 1994, the Asian financial crisis and the 1999 devaluation in Brazil are blunt reminders of the chaos that can be created by deregulated international financial markets, and make clear the urgent need for a new architecture to control the international financial system.

Since the start of the current crisis, the strategy employed by the International Monetary Fund (IMF), the World Bank and the G-7, which make economic policy decisions at the international level, has been an ill-defined one. With the spread and deepening of the crisis, and an increasing toll of human victims, it is now clear that their containment strategy has failed. The cause of the crisis lay in a blind pursuit of financial liberalization on the part of the policy-making class, along with monumental greed by those who speculate massively with the world's financial resources. Financially corrupt institutions enjoyed what amounted to sinecures courtesy of the policy-making class, allowing them to proceed without regulation, transparency or accountability.

The consequence is the destruction of decades of hard work, and a massive increase in unemployment and poverty. Society's most vulnerable groups, which bear no responsibility for the crisis, are those that suffer the brunt of the policy failure. As increasing recession pushes more and more people into indigence, the wealth of the 225 richest people in the world has increased by more than a trillion dollars, which is equivalent to the annual income of 47% of the poorest members of the world population, 2.5 billion people. A system based on these enormous inequalities is socially, morally and politically unsustainable. And while the crisis gained force, the IMF, World Bank and national governments attempted to demonstrate that they were capable of making decisions to restore financial and social stability and lay the foundations for recovery.

The crisis began in Asia, but there can be no doubt that it reached Latin America. At the 1998 annual meeting of the Inter-American Development Bank (IDB), predictions were made that Latin America would be in recession in 1999 as a result of high interest rates, low commodities prices and a sharp reduction in capital inflows. Predictions called for the Brazilian economy to contract by at least 5%. Contraction was also forecasted for the economies of Argentina, Ecuador and Venezuela.

Our immediate priority must be to fight to prevent recession from turning into depression. In the service of this priority, the world's leaders must design a coordinated strategy for international recovery. The world's greatest industrial powers must take immediate action to prevent the collapse of Latin America's economies, given that there is a massive flight of capital from emerging financial markets such as Brazil's.

The ICFTU believes that concerted action on a large scale is essential to avert the danger of a deep and prolonged world recession, and it has advocated the following steps to that purpose:

- A massive increase in financial assistance to developing countries and countries in transition, directed at the front line of the crisis and destined for social programmes and restructuring of private and public debt.
- Substantive reforms in the architecture of the global financial system.
- Coordinated reduction in the interest rates of all OECD countries.
- Support for the consolidation of democratic institutions and principles of good government, including respect for basic workers' rights.
- A determined offensive to eradicate poverty.

The industrialized countries should immediately establish a large-scale contingency fund to reinforce foreign currency reserves. If another Latin American country falls, there could be a domino effect throughout the region, holding back efforts to reduce unemployment and social inequality.

Only when Long Term Capital Management (LTCM) fell apart did we perceive the possibility of a hedge fund with only US\$ 2.8 billion in assets controlling US\$ 400 billion of investment. Investors had no way of knowing where their money was being invested. The world's elected leaders must show that they have the strength to face the tyrants of the financial world through regulation and by using financial markets to facilitate productive long-term investment and thus assure growth and prosperity that is widely shared.

Their decisions should:

- lay the foundations for an international tax on currency transactions
- acknowledge the importance of minimum deposit requirements to discourage the influx of short-term speculative money
- reach agreements on binding international standards for preventive regulation of financial markets
- ensure that banking systems are transparent and are governed by effective standards for publication of information
- improve norms of corporate governance and standards for publication of information
- improve information on currency flows, private debt and reserves.

The world needs:

- stricter global rules on bribery and corruption and
- a consolidated international code of practices to govern both decision-making and implementation processes.

The Asian crisis made it clear that ignoring the social dimension of globalization is dangerous. The economic miracle years disguised the fact that

many of the countries in crisis did not permit, let alone encourage, the development of democratic unions. The miracle years also disguised the unacceptable growth of child labour, forced labour, exploitation of women workers and many other forms of labour abuse.

If the world's leaders believe what they preach, in the sense that globalization should take the needs of the world's peoples into consideration, they will insist that the next conference of the World Trade Organization (WTO) in Seattle in 1999 include, in a new round of WTO negotiations, the core labour standards that are part of some ILO agreements, that a decision be made to consolidate cooperation between the ILO and the WTO and that the Conference insist on internationally recognized core labour standards being integrated in every facet of the activities of the WTO. They should also recognize that this financial crisis has dramatically demonstrated the value of and need for social dialogue between governments, unions, employers and other representative collective organizations if a consensus on national social and economic development objectives and instruments is to be reached.

Beyond the crisis, the ICFTU firmly believes that those countries that have more social cohesion, based on investment in people through education and training, a health system and a solid labour relations system based on basic workers' rights, enjoy a legitimate and socially acceptable comparative advantage. If governments wish to shape globalization into a force that allows peoples to realize their aspirations and deal with their fears, they must guarantee their peoples' rights to express themselves on the terms and conditions of their employment.

The 86th International Labour Conference in June 1998 approved the ILO Declaration on Fundamental Principles and Rights at Work, a basic component in the creation of a more humane and less volatile market. The Declaration should be a part of the new architecture governing the global economy and should provide a basis for the social code that a number of leaders in government have asked for as a condition for assistance from the IMF and World Bank.

Preventing a global depression and consolidating the foundations on which a recovery of sustainable development can be based is not only a subject for economists and bankers, but a challenge for the leaders of the main democracies in the industrialized and developing worlds.

Globalization is a human process, not a force of nature, though it may at present sometimes appear to be beyond control. The world could return to protectionism and isolation, and there are dangerous pressures that make this a possibility. However, movement in this direction would impede any global effort to eliminate poverty and would destabilize international relations and the search for peace, security and disarmament.

The concrete question that the international community faces is: 'Can we create policies and institutions, both at the national and the international level, to manage the process of globalization in such a way as to put it at the service of the needs and aspirations of the world's peoples?' Like the Mexican journalist and writer Carlos Fuentes, we believe that the most dangerous aspect of globalization is the dominance of speculative capital over productive capital. Three decades ago, 80% of capital flows in the world were productive and 20% speculative. Today, those percentages are reversed: 80% of the US\$ 3 billion that circulates daily at the speed of the Internet creates no jobs or wealth, let alone fund education or health services. However, capital flows do have the potential, as Fuentes correctly points out, to be a monstrous gambling operation that destabilizes national currencies and even the sovereignty of nations, all in the name of globalization. Like drug trafficking, speculative financial flows are not controlled by national governments or by any international authority. They make a mockery of social considerations and their lack of accountability carries with it the promise of financial and social disaster along the lines experienced by Brazil, Japan, Malaysia and Russia.

It is the view of our labour organization, which includes more than 130 million workers in 126 countries, that the globalization process is more than likely irreversible, but that its present logic must be turned around to prevent unprecedented social and human damage which could only lead to chaos and to confrontation between two human groups: the haves and the have-nots. A system that permits one country (the United States) to spend US\$ 9 billion on cosmetics during a single year, while it is unable to provide a similar amount to guarantee basic education in poor countries, is due for thorough study and urgent change. The irrational logic that allows US\$ 800 billion to be spent yearly on arms, at the same time as it claims to be unable to provide US\$ 6 billion a year to ensure that the world's children have access to a primary education, must at all costs be turned around, if the potentials of globalization are to become a reality.

19. WHY COMMON GOOD MATTERS

Jean-Loup Dherse *

The ‘common good’ concept has to be defined precisely. ‘Common good’ does not equate with public interest, itself a hazy concept sometimes brandished by government departments or public authorities in support of their own institutional ambitions. It does not coincide either with the market, equally brandished by private sector institutions for similar purposes. Nor does it with the economists’ optimum, where John’s loss (and suffering?) is cancelled out by Peter’s gain: where individuals do not count, only the aggregate is meaningful.

Somehow, both the good of the individual and the good of the community are important and should be promoted:

- Concentrating exclusively on the *good of the community* without any respect for the good of the individual is a recipe for totalitarian dictatorship, such as those which still exist today. Their archetype was the Soviet system of government. China -are the Chinese more clever than the Russians?- seems to succeed in developing its economy while keeping the lid very tight on the dissidents, with huge financial contributions from all over the world, including Taipei, the United States and Europe.

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- On the other side, a total lack of interest for the good of the community, letting the *good of the individual* be the dominant factor leads to disasters such as a worldwide debt crisis, a revolution here or there, all sorts of unpredicted events of major importance which take place before the eyes of amazed forecasters. History does not comply with theory, if only because men and women loathe to behave as programmed robots and want to make use of their freedom of choice. Equations -however complex- cannot describe individual human behaviour, even within some margin of error. In my opinion, they never will. One can make a similar case concerning human group behaviour. Economics is a wonderful body of knowledge, not an exact science. Mastering it requires being able to judge it from outside, to get out of the wood in order to have a look at the whole forest. The good craftsman knows when his tools become inappropriate.
- Somehow one has to combine in one single concept the good of the community together with the good of each of its members: this is the best definition of the common good. This may look like a cheap compromise. It is in fact a profound concept, adjusted to the fact that each human individual is *at the same time unique* and also a *member of the human community*.

The common good can be a very useful concept. Our daily work, whoever we are, can be compared to our moving ahead on a narrow road, between two deep ditches on a foggy day: one where the good of the community is dominant: this is the totalitarian ditch; the other where the good of the individual is considered exclusively, and this is the mafia ditch. The common good is the compass that we need -in the fog- for progressing (from one decision to the next) without falling into either ditch.

Applying the common good concept in every decision we make is another matter. Many have tried to find a formula, but without much success. Fortunately, and this may be new, there is no need to articulate a more precise definition of the common good: we have a criterion for finding the option that favours the common good in decision-making. A rather simple approach is proposed, which is acceptable by everyone including the less literate, but is also important to top decision makers.

Complex situations (all situations are complex, with very few exceptions) can and should be considered from four different sides. This is especially valuable before making decisions. The four sides are:

1. The *measurable* or *quantitative side of reality*: a 'bottom-line' approach, always needed and justified, but never sufficient. The question is: which decision will give me (or the institution I work for) maximum profit in quantitative terms? Everyone understands this.

2. The *structural side of reality*: we all work within organizations, or structures, that are far from being perfect. Structures, even after much improvement, can be impediments for the good of the community and for the good of individuals -i.e. for the common good. We have little choice but accepting to work in them, even when they are very wasteful or unjust. While we work in them, we can bring a spirit of reform, and assist those who try to do the same. If we choose to rebel against the structure we work in, we may prevent others from working at all, and start a crisis the cost of which is born by the community. That can be the thing to do under extreme circumstances (as dissidents courageously do) but this is acceptable only when structures cannot be reformed, which is the case in totalitarian regimes.
3. These two levels are far from accounting for all sides of reality. The third one deals with the *quality of personal behaviour*. Are we, in the decision we contemplate taking, fostering or destroying mutual trust between people? Mutual trust is always needed for risk-taking, and risk-taking is a requirement for progress. There are only very poor substitutes to mutual trust: if my colleagues or partners do not trust me, I have to force or buy their collaboration. The totalitarians and the mafiosi do just that. The result is not as good. Mutual trust is highly valued in all cultures, ancient or recent. It has, it is a universal value.
4. There is a fourth side that the decision-maker can and should consider explicitly before making up his or her mind: what is his or her key purpose in the decision to be made? *Three types of motivations* can be involved in any decision: personal rewards (in terms of money, authority, reputation, pleasure), institutional objectives (the institution is the group we work for: government, corporation, NGO, etc. ...), and lastly the good results that people, nearby or at large, may experience as a consequence of the decision. The three motivations: personal, institutional and, shall we call it, altruistic) are all perfectly legitimate.

One of the three motivations is usually, consciously or unconsciously, dominant. Here a most important finding can be made: when we have a problem to solve or a task to perform, our decision may be very different depending on which one is our strongest motivation. The first three sides of reality must be taken into account, but our ultimate goal, even if unconscious, determines the choice we will make.

An example that readers will readily understand is the case of a major World Bank loan (US\$ 500 million) to Brazil, to finance the production of alcohol from cane and cane sugar, and its use in substitution for imported petrol. A first loan was made in 1982, and the 'green oil' helped the balance of payments, but it also caused a number of families to be uprooted and (in spite of a fair compensation in terms of money) to become vagrants in the country: it is indeed very difficult to buy farm land in Brazil. A further special loan was

made by the Bank in order to help the government develop infrastructure required for letting these people settle in a very remote part of the country, at the foothills of the Andes near Peru. The question that was raised within the Bank was: should a second loan be made, for producing more 'green oil'?

I took advantage of this question to make a case study within the Bank: assuming (for the sake of convenience) that the decision is made by a Bank officer, three possible decisions can be made:

- If this officer is motivated mainly by his *own career* in the institution, he will propose that the loan be made, and he will do his best to minimise the social problem. Bringing a major new lending operation brings good marks, even in the World Bank.
- If the officer is motivated mainly by the *Bank's interests*, he will propose that the loan be made with conditions designed to shift off onto the Brazilian government the risk of any adverse media reactions concerning the social issue. A good bureaucrat knows how to draft such conditions.
- If the officer is motivated mainly by the interests of *people in Brazil*, he will do his utmost to find a better solution to solve the problem, helping all Brazilians but not at the expense of a group of people. He will dig deeper into the issue for Brazil -its prime concern- which is not to produce 'green oil', but to develop local oil resources, at a competitive cost.

In this test case an excellent solution was found possible: allowing Petrobras, the national oil company, to accept foreign companies as partners in offshore exploration. Once a sensitive political decision and a change in legislation were made, Petrobras admitted foreign partners who took 100% of the risks against 50% of the production rights, and were allowed to run the operations both at the exploration and production stages. Exploration started offshore and a lot of oil and gas was discovered at a much better cost than any 'green oil' and without having to send tens of thousands of additional families on the road.

The three solutions are professionally correct, but one only is outstanding. It took a lot of courage and determination to refuse making the loan, and to convince the Brazilian officials to move in another direction.

What the loan officer did in the third case was to pay attention to those who were going to suffer damage from his decision, although they had no specific weight in the issue. The question he asked himself before reaching his decision, was: 'Do I consider the other people, especially those who will suffer from my decision and who cannot defend themselves and hurt me, as tools for my own purposes, or are they persons (one could say "unique individual living beings") that I do not necessarily understand, but whose interests I respect.' More briefly: 'Is the other a mere tool or a unique individual living being whom I therefore must respect?' There are no real alternatives, when we

dig into the real issue. The problem is that we very seldom look at the consequences of what we do beyond the narrow circle of those who can help us or fire back on us.

Considering other people not as 'mere tools' but as 'unique living beings whom I must respect' means 'caring for people' because they are people. It is an attitude of unselfishness, which does not lead necessarily to 'softer decisions', but to 'other decisions'. This caring for people, or concern for people, is the practical, easy to understand, way to aim at the common good, however difficult this concept may be.

The common good is not a luxury. One can show easily that those who just do not care about others when they make a decision will cause three types of damage to the world or to society:

- They will get increasingly blind: not caring about others becomes a way of life, where one forgets that purposes in life could be quite different.
- When a group of people behave without 'caring for people', and when someone who does care for people steps in, this poor newcomer may well find himself in a dilemma: he will have either to forgo his values in order to be admitted and survive, or to be excluded, perhaps violently. The newcomer suffers a grave injustice. Selfishness on the part of some compels others to heroism. Such vicious processes are present everywhere: corruption in some business sectors, gangs of youth in some suburbs, etc. ... Lack of concern for people (and therefore for the common good) literally wounds other people, and society, which in turn becomes dangerous for everyone.
- Lastly, and this may be a surprise to some, lack of care for the common good causes major macroeconomic losses or comparative losses. Between two scenarios, one where the decision-maker cares and the other where he/she does not care for the common good, one can always pinpoint a macroeconomic difference. A major example -at the level of the planet- was the decision to produce chemical weapons by the Soviets after the Second World War. Their cost of production, and of destruction (still to be undertaken) may reach \$ 200 billion. There are no positive economic fall-outs, and huge secret cities were built, without any other activity, nor respect for the environment. All this is a straight loss. Because money is fungible, one can say this production was financed by the West, and future destruction certainly will be financed by it. The costs are immense, to the former Soviet community, to their heirs and to the whole planet. One can find smaller-scale examples: the member in the decision-making team that becomes overobsessed by his ego (greed, or desire to hide his weaknesses) is a cause for delaying decisions and corrupting its content, causing a cost to the institution that will not be fully made up by someone else. This loss is macroeconomic: the selfish decision-maker may well

profit from his attitude, even in the long term. Crime can pay, but its cost to the planet is huge, much bigger than its benefit, far beyond the amount wrongly made. This is a major source of poverty in the world. Indeed financial burdens tend eventually to spread throughout the world, and the poor are always at the end of the line. Lack of care for the common good leads to further poverty and therefore to spreading hunger. There are 800 million hungry people in the world.

Fortunately these vicious circles can be reversed. There is no medium, or indifferent, position. Either I care for people in the decision I make, or I do not. If I do, positive consequences will emerge:

- I will develop a keener judgement on the consequences of what I do and do not do.
- If I team up with others like me, it will become more difficult for a newcomer to play a selfish game: he will be more visible and may risk being rejected.
- Some macroeconomic (comparative) loss will not take place and the world (though not necessarily me) will be richer.

We can therefore put our finger on why the common good matters in such very concrete terms. All decisions are important, even in the world of finance which looks so far from the grassroots in many respects that what is bought or sold seems to be wholly abstract, far from people and their process of daily living.

But this is not the case: everything we do has consequences on people, however remote they may be. These people have faces, even though we may never see them. Without developing any vague sense of guilt, let us make sure that if one day we see their faces, we can tell ourselves that we have worked for them, and not against them.

20. ETHICS AND THE FINANCIAL COMMUNITY

*Andrew Hilton **

Whenever I write about morality and finance, I am always tempted to point out that ‘there’s money in poverty’ -at least in other people’s poverty. And, as someone who spent five years at the World Bank, I know all about the *culture of entitlement and victimhood* that distorts much of the debate about morality and money. I also know that this is a debate characterized by envy, sloppy thinking and hypocrisy.

Don’t think me some stonyhearted flat-earther from the Cato Institute, who believes that the poor should be left to burn. But I have noticed:

- that many of those who agitate most stridently for imposing tougher ethical rules on finance (and on business more generally) tend to assume that there is something inherently Hobbesian about contemporary capitalism -viz. that it is bound to rape you if you stand around and let it
- that there is still a great deal of selectivity in who gets the blame for corruption, or lax ethical standards, particularly when emerging markets are concerned and
- that some of our most prominent environmental or ethical activists are extremely comfortable taking the corporate shilling by sitting on more or less meaningless boards that have been set up precisely to buy off some kind of pressure group.

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I hope that I don't fall into those same intellectual pits. However, the confluence of ethics and business is a very difficult subject to tackle.

My topic is the financial sector. In the United Kingdom, we call it 'the City'; in the United States, 'Wall St'. Whatever, it is not 'Main St'; it is not a country's industrial or extractive base. Rather, it is the financial infrastructure; the plumbing. Basically, it consists of retail and commercial banks; investment banks; and fund managers.¹

In my opinion, any serious discussion of ethics and morality is bound to look rather different depending on which subsector one focuses on. However, before I try to look at the issues raised in each subsector, I want to point out one very obvious but easily-forgotten factor that differentiates the financial sector from the 'real economy'. I have called it the *fiduciary factor*, by which I mean that most of the money that banks, insurers and fund managers put at risk belongs -not to shareholders of those institutions- but to depositors, savers and investors, policy-holders and pensioners. I think this is crucial to what we are discussing. In a way that is not true of shareholders in, say, General Motors or IBM, these folk have a legitimate expectation that the money they have placed will not be squandered and that it will deliver broadly the kind of return that was promised with roughly the level of risk that was advertized.

I have been deliberately a bit weaselly in the words I have chosen. And I know that there are specialist proprietary trading houses that have no greater fiduciary duties towards the public than does the average manufacturing company. But, in general, the uniqueness of the financial services sector is that it is the vehicle through which we defer gratification, through which we give wealth a time dimension and through which we make provision for a rainy day. This is a real difference from, say, selling tyres -and it is the reason that every country in the world regulates financial services more tightly than any other sector.

Now, let's turn to individual financial subsectors, since I believe that they all pose rather different moral or ethical issues.

1. Retail banking

The role of the average retail bank is unique. Although, in many ways, it has seen its franchise eroded by money market funds and credit cards, it still provides the basic plumbing of capitalism. If it works, we can be sure payments get made, that savings are secure and that sound businesses have somewhere to turn for credit. But there is a downside. Because banks are specially regulated, the normal rules of competition are suspended and, in

1 It also includes insurers, and other smaller sectors; but I shall limit myself to these three.

most countries, they increasingly behave like oligopolies. We see this particularly in the United Kingdom, where returns on bank capital are very high. So charging practices (for whatever service) are a legitimate issue -and a moral one, since it is the poorer and less sophisticated elements in society who are most vulnerable to overcharging.

The second legitimate ethical concern raised against banks is that, as a regulated oligopoly, they ought to think long and hard before ruling out classes of borrower (e.g. in poorer immigrant communities). As I have argued, banks have a fiduciary responsibility to depositors and savers not to squander funds on indiscriminate do-goodism. But the protections that government regulation provides come with a price: and if business can be done profitably in a community, a bank should not arbitrarily abandon that business.

I concede that this is a murky area. And, indeed, I think that CRA-type legislation can be counter-productive if it just sets quotas. But, so long as banks shelter under the government's regulatory umbrella, they should be unwilling to write off classes of business for which no immediate alternative may be available. Granted, banks -which have allowed themselves to grow fat under the government umbrella- may not be the best way of serving these communities. But I think they have an obligation to support new approaches such as, for example, innovative smart card programmes targeted at the disadvantaged; microfinance, credit unions and community banking; and the encouragement of the broader mutual sector.

There is the very interesting example of Farmers Insurance in the United States. Owned by Zurich Financial Services, it is profitable -but its profits come, not from insurance itself, but from servicing a series of mutually owned farm insurers. This is an approach that, with a little tweaking, could give banks a way of making money by servicing groups that would otherwise fall through the net.

That is really as far as I am comfortable going with the banks. The other big ethical issue that tends to be raised, is their support (usually through syndicated lending) for environmentally damaging projects or for technologies that one pressure group or another feels are dangerous, sexist or culturally offensive. Three thoughts come to mind:

- These cases tend to be terribly subjective, and right and wrong is almost never clear. Family planning projects are an obvious example. But it is easy to look around Latin America and see lots of other examples -Carajas in Brazil, for instance, trading employment off against environmental degradation. It is much easier to knock these projects from a Washington armchair if you know where your children's education and your pension are coming from.

- Commercial banks may provide funding for these deals, but they very seldom initiate them. The banks simply don't have the resources to do a comprehensive evaluation of every project to which they lend.
- If governments feel this is a legitimate issue, they can always stop their banks lending.

There is another area that I am uncomfortable with -one that applies as much to insurers as to banks. That is the current furore over Holocaust reparations. There is a clear consensus that European banks and insurers behaved reprehensibly in spiriting away the monies that Jewish victims of Germany placed with them in the 1930s. Equally, there is no doubt that banks like Dresdner financed camps like Auschwitz. But I am very troubled by the premises under which some groups are operating: too often, moral considerations appear to be losing out to a sort of crude blackmail that does no one any credit.

Finally, banks are regularly castigated (not least by Transparency International) for not being assiduous enough in checking that money deposited with them is not of criminal origin. There is some truth to this. Even I know private bankers who have made a good living trawling Latin America for business, while turning a blind eye to where the suitcases of cash come from. But the rules are genuinely much tougher than they were, and banking privacy is much less of a protection, even in countries like Switzerland -at least where criminality is involved.

2. Investment banks

This is a very broad term, and I am going to include within it the most controversial areas such as derivatives trading. Basically, investment bankers do anything; whatever it takes to make a buck. Here, in my opinion, it is very difficult to separate out legitimate ethical or moral issues from simple envy. Is the fact that the average partner at Goldman Sachs can sell his stake for US\$ 40 million a moral issue? Is the fact that the average annual remuneration at Goldman (and that includes the cleaners) is around US\$ 200 000 a moral issue? Is the fact that a very average bond trader can easily earn US\$ 2 million a year, when his college peers are making US\$ 25 000 as high school teachers, a moral issue? Maybe; but these are issues about the priorities of society; they are not specific to investment banking. They apply *a fortiori* to pop stars, basketball players and divorce lawyers.

I think a more legitimate issue comes from the fact that, Chinese Walls and separate capital notwithstanding, there is a tendency for investment banks to exploit their regulatory status -essentially, to punt what should be risk-free

funds, in the knowledge that there is some kind of regulatory backstop, or to use that backstop to lower the cost of borrowing for essentially unregulated purposes. One shouldn't overdo this; in the most egregious example, for instance, the case of Barings, it is very uncertain whether any 'widows and orphans' were seriously damaged. But it is at least a potential problem.

I suppose investment banks are also susceptible to the charge that they ought to look more carefully before endorsing any particular project. By raising funds in the market, an investment bank does signify its endorsement of a deal. But that is only a limited endorsement. It says (for instance) that the project and the principals are where they are and who they are, that the accounts are fairly presented and that no obvious criminality is involved. But investment banks, often based thousands of miles away, cannot provide a blanket assurance that everyone involved with a project has always been squeaky-clean. Similarly, on the environmental side, it is very difficult for an investment bank to go much beyond ascertaining that no domestic or international norms are breached.

That said, I think that investment banks do find themselves peculiarly susceptible to what is called the *principal-agent problem*. Essentially, what it says is that there is an asymmetry of risk and reward in the way investment banks are run and staff are remunerated. Employees' compensation is directly tied to the money they make for the firm -which means that they are encouraged to trade right up to their limits. If they win, they are rich; if they lose, the worst that happens to them personally is that they get fired -no great handicap in a notoriously mobile industry.

3. Fund management

If, all in all, I cannot get too steamed up about the moral issues raised by investment banking, I can get pretty hot and bothered about the fund management industry. Here, I think the fiduciary aspect is crucial -but I fear, it probably runs counter to what many mean by 'moral' or 'ethical' issues. All over the world, people are being encouraged (or forced) to make provision for their old age, for health care, for the education of their children etc. And, as the government continues to retreat from areas where it cannot outperform the private sector, this will continue -which means that we will all be increasingly in the hands of national and international fund managers.

What do we want from these guys? Do we want them to save the planet? To redistribute our savings to the poor of Jakarta or Kinshasa? Or to ensure that we enjoy a moderately comfortable retirement and that our children are educated? Given how ignorant we all are, what we want most of all, is an assurance that we are not being ripped off, and that our expectations

concerning any investment we may have made are not unreasonable. In other words, we want honesty, clarity and transparency before we want to change the world. In fact, however, the fund management industry is notoriously opaque. One can say with some confidence that the fee structure of the actively managed unit trust industry in Britain is a scandal. It is much better in the United States. But this is an area ripe for root-and-branch reform -and, given the importance of the sector, it cannot come too soon.

What you will notice is that I have paid very little attention to ethical or moral issues as commonly understood. In the best Anglo-Saxon tradition, I have eschewed big issues like God, the future of the planet, the unfairness of global income distribution and justice, in favour of little-think, pragmatism and (in the words of Bishop Butler) 'cool self-love'. Given the moral quagmire into which one can all too easily step, I think that is an eminently defensible position. Let me take the fund management industry again, because that is where I believe the most pressing moral issues lie. In my opinion, the main ethical or moral issue that we ought to consider is whether the investor -who is being encouraged by his government to make provision for his own future, and for that of his family- is being ripped off by an industry:

- that may take huge up-front fees that are not easily identified
- that tends to be economical with the truth when it comes to publicising historic returns (subpar funds tend to be folded into above-average ones, to hide poor performance) and
- that routinely fails to outperform much cheaper tracker or index funds.

That is the key moral issue -not whether the fund in question invests in tobacco or defence stocks, or whether it has a policy on female circumcision. It is a moral issue because provision for one's own future is a moral issue, because provision for one's family's future is a moral issue, because truth is a moral issue.

That is not to say that where the investment management industry chooses to place its money should not be affected by moral or ethical considerations in the sense that activists understand the term. If any people want to entrust their life savings, and their children's education money, to the Calvert Funds, for instance, or to Gaia or to any 'ethical fund', that is their right. They may get what is called a 'double bottom line' -and it is true that a warm glow can compensate for some shortfall in the financial return. But one should not kid oneself: while some 'ethical' funds do just as well as some mainstream funds, the general truth is that restricting investment to a much smaller universe of companies also restricts the return. I have no problem with that -provided that the fund manager is up-front about it and provided that the investor feels he can afford to share his wealth in this way.

Equally, I have no problem with the City of New York or the State of California putting 'ethical' requirements on the investment policies of its retirement funds -provided, again, that those whose future benefits are being jeopardized are aware of this and have given their approval. If the City of New York wants not to do business with a German bank or an Italian insurer because of what was done in another country 60 years ago, fine -but those agencies should explain to the electorate that this kind of selective morality carries a price tag.

At an even broader level, I am, equally, fully supportive of the same kinds of rules being imposed at a national government level. There is nothing intrinsically wrong, say, with the currency-matching rules that European pension funds had to follow prior to the euro -provided, again, that the rules were transparent and that the future retirees were aware of what was going on. Equally, there is nothing wrong with governments requiring markets to price pollution or social responsibility in a much more up-front way. In my view, it is the legitimate role of government to set rules, and it is the role of business to act within those rules. If the Chilean government tells Provida, for instance, not to invest in British equities because of the Pinochet affair, that is fine by me -if it is fine with the Chilean electorate. If the UK government blocks my pension fund from investment in Chinese stocks on human rights grounds, that, too is OK -provided I have a chance to make my views known at the ballot box and provided the costs of this inevitably selective morality are made known to those who are likely to have their future benefits diminished.

21. A CHALLENGE TO GLOBALIZATION THEORY

William Pfaff *

I wish to make the argument that the assumptions underlying globalism are recent in origin and open to challenge. They will one day belong to economic history, just as Keynesianism, and before that the orthodoxy of gold, now belong to history. If this argument is correct, the contemporary debate over economic policy is one in which there are real choices.

It is necessary to take account of the intellectual as well as the political origins of the policy of global deregulation adopted by the United States under the Clinton administration, pursued by it with great energy and success, acting through not only the agencies of the US government but the main international economic and financial institutions upon which the United States exercises predominant influence, and generally acquiesced in by the international community.

An economic policy inevitably reflects a certain vision of society as a whole, and not only of the economy. The dominant Keynesian economic practices and expectations of the post-war West represented one such economic vision, and expressed certain assumptions about the social obligations of economic actors. Similar assumptions prevailed in post-war western Europe, under the influence of the Christian Democratic and Social Democratic parties which cooperatively developed what became known as 'social capitalism' or the 'Rhineland model' of capitalism, and eventually invented the European Community (EC), a model of constructive economic cooperation and liberalized trade.

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A different vision prevails today, one which places faith in the self-regulating market as the basis for economic growth and development, attributing to it the power to produce social progress as well, identified in terms of wealth. It is hostile to the demand that market mechanisms be subordinated to some particular vision of social justice. This neo-liberal economic doctrine holds that the free play of the market, extended to the globe itself by means of universal deregulation, will have ultimately benign consequences, whatever the interim difficulties that may appear. A deregulated universal labour market place is held to be in society's best interests, whatever the incidental injustices it produces, and the workings of unregulated corporate capitalism are held to be constructive in ultimate effect, contributing to the wealth of nations and the eventual enrichment of the individual members of society. All of this ordinarily is put forward as beyond serious challenge. It is an orthodoxy.

These conventional beliefs about the workings of the globalized market place, and about appropriate corporate conduct, nonetheless are worth challenging. I would myself contend that as a vision of society they are too narrow, defective in their social and political assumptions and values, lacking historical depth. There certainly are ascertainable truths about the economic behaviour of men, as about their political behaviour, but there are no laws in economics which resemble those of physics or chemistry, which allow scientific forecast. The philosopher Karl Popper remarked many years ago, in his famous essay 'The Poverty of Historicism', that the growth of human knowledge creates a situation in which 'we cannot anticipate today what we shall know only tomorrow'. Humans confront an ubiquity of choice. Economics and politics are the study of human experience and human conduct. They are not sciences in the proper meaning of that term. This we all know. The conventional public and government discourse today ordinarily holds that deregulation and globalization are natural -and, indeed, inevitable developments which follow from technological development and organizational innovation.

However, deregulation as a programme is also the product of an ideology with political as well as economic sources. One must distinguish the objective sources of the globalist orthodoxy from those which are ideological and self-interested.

This belief that market forces will automatically enforce the general interest was not universally shared among western political economists 30 years ago. It originated as the sectarian enthusiasm of a minority of writers and theorists in Britain and the United States, beginning in the 1970s, and derives more from their political hostility to so-called 'big government' than from economic analysis as such. Its principal intellectual progenitor was Friedrich Hayek, whose arguments concerning free markets included the

contention that government regulation in the economic sphere is connected in a fundamental way to political tyranny -that it is, as in the title of his best known book, 'the road to serfdom'. This conviction was rooted in a specific Austrian political experience and in Hayek's hatred of the totalitarian politics that emerged in Central Europe (and the Soviet Union) during the 1920s and 1930s.

While the centrally directed economy was integrally connected to political tyranny in Soviet Russia and the states which emulated it, no such connection existed in the Scandinavian social democracies of the same period, or the New Deal of Franklin Roosevelt, nor later, in the centralized and planned economic structure of post-war and Gaullist France, or the highly regulated social market capitalism, or 'Rhineland capitalism' of West Germany.

Hayek's arguments had a particular resonance in the decaying British welfare state which Margaret Thatcher took over in 1979, at a moment when the Keynesian model for international finance was also foundering. Inflation had accelerated under the impact of the US economic policy during the Vietnam War and the abandonment of the Bretton Woods system. His arguments against the existing Keynesian consensus found a natural response in business circles in Great Britain and the United States, and particularly in the financial community, and they inspired the political as well as economic policies of the Thatcher government and its successors in Great Britain. In the United States, which has a long native tradition of hostility to big government, these arguments and precedents from Great Britain provided a respectable rationale for the business-inspired policies of the Reagan and Bush administrations.

The *New York Times* provided a remarkable service to clarification with a series of major articles, published during the week of 15 February 1999, on the origins of the policy of globalization adopted by the Clinton administration. The paper documented the process by which a programme for deregulating the international economy was proposed to the Clinton administration (indeed, to Mr Clinton himself while he was still governor of Arkansas) by leading figures in the New York financial community. Mr Clinton, who was largely innocent of economic sophistication, was convinced by their arguments, and when he came to power he made aggressive pursuit of global trade deregulation a major theme of his administration. The political as well as economic power of the United States was mobilized to promote radical change in the world financial system.

The success of this campaign produced a fundamental change in the world economy, with consequences yet to be fully felt. Goods and commodities were replaced as the principal components of international trade by stocks, bonds, and currencies. That is to say, the global financial

market replaced the global economy. The total worth of the financial derivatives -leveraged financial instruments- traded in 1997 was 12 times the worth of the entire world economy.

The *New York Times*' account says that 'Although the Clinton administration always talked about financial liberalization as the best thing for other countries, it is also clear that it pushed for free capital flows in part because this is what its supporters in the banking industry wanted'. And of course when the Asian economic crisis arrived in late 1997, the western investors who had profited from globalized markets worsened the crisis by speculating against newly weakened currencies, and the US government used its own resources and those of the IMF to rescue western investors and North American and European banks (as now is generally acknowledged). The countries which were the victims of the crisis were at the same time pressed by Washington and the international lenders to adopt measures of austerity, imposing severe economic and social costs on their populations -also a policy which is now widely thought to have been mistaken.

I do not quote the eminently respectable *New York Times* to suggest that globalization was the result of a conspiracy of bankers, but to make the point that the experience the international economy has undergone during the past few years was not the product of objective forces arising from the nature of the economy itself, or of irresistible technological forces, but was deliberately produced as a matter of policy by a government acting in good faith, but also in what it considered to be its national interest, and in the particular interest of important and influential political constituencies, the financial and corporate communities.

It was a programme –an experiment, even– inspired by a set of beliefs, or, to be more accurate, by an ideology, which was political in ultimate origin. Some other international economic policy could as easily have been followed by the Clinton administration, and we would not be here today, discussing the consequences of financial globalization.

I would stress that alternatives exist to the neo-liberal ideology which underlies the globalization programme. There is, obviously, European social market capitalism, product of Roman Catholic social thought and the Social Democratic tradition. There are versions of neo-Marxist thought, and so forth. It is possible (following John Gray of the London School of Economics) to interpret globalization as a utopian experiment, the legitimate successor to Marxism as a programme for global transformation, the latest example of the western utopian tradition that began in the Enlightenment, an example of western hubris.

In a conference in which one of the organizers is an institute devoted to the thought of the neo-Thomist philosopher Jacques Maritain, it seems

particularly appropriate to challenge the untrammled secular optimism which underlies the utopianism of globalization ideology, and oppose to it the values of an integral humanism. The well-being of the individual human person is the proper criterion by which economic as well as political policy is to be judged, and which is hostile to all arguments which justify doing harm to people in the short run with an explanation, based on theory, that good will result in the long run.

I would cite the notion of justice in Greek philosophy, which was a source of Maritain's thought. Classical political philosophy held that the purpose of political action, which would have included economic policy had that existed in any formal way in Greek society, was to produce justice -not wealth, and not even happiness, since the Greeks understood that existence is fundamentally tragic. Justice they defined as the rendering to individuals of their due, which assumes that each person possesses an inalienable 'due,' which is to say, rights.

Justice was held to deal with the relationships among autonomous persons with legitimate claims upon other individuals and upon society, possessing rights to be respected. The various utopianisms of our century have all rested on a belief that human progress takes place, and that the growth of knowledge, and technological and scientific enrichment, can provide an ultimately perfected society. Marxism, despite its dialectical materialism, preserved a vestige of classical thought in describing its ideal society in terms of justice rather than wealth. Our new utopianism, by measuring itself, and justifying what it does, in terms of wealth production, in that respect represents a retrogression.

22. DEALING WITH 'THE GLOBAL GOVERNANCE' AND 'THE DUAL CONSTITUENCY' SYNDROMES IN EMERGING COUNTRIES

Louis Sabourin *

1. Introduction

The purpose of this chapter is to show that emerging countries, in their search for a so-called 'Bretton Woods II' on the world scene and for more democracy and development at home, have to cope with two major phenomena that I characterize as the *global governance* and the *dual constituency* syndromes which I will briefly and successively analyze here.

The evolution of the economic and financial situation in recent years, especially in Asia, the ex-Soviet Union and Latin America, on the one hand, and the reaction of the Bretton Woods institutions, on the other hand, reminds me of the famous 14th-century painting by A. Lorenzetti in the Palazzo Pubblico, in Siena. The text of the scroll shown on the painting representing 'Mother Security' reads like this: 'May everyone move freely and without fear devote himself to work in the fields, while our Lady Security governs the community and shelters it from arbitrary power.'

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Of course, the nature of security has several dimensions and depends a great deal on what one has in mind, notably in an environment which varies from one part of the world to the other, where paradoxes are more the norm than the exception. But today's financial and economic security of several countries has much to do with the International Monetary Fund (IMF) and the World Bank. Indeed, it may look strange to many people that the Executive Manager of the IMF, Michel Camdessus, was able to go to Moscow to renegotiate financial agreements, only a few days after the Russian Prime Minister, Yuri Primakov, decided to go back to Moscow -interrupting abruptly his trip to Washington. It demonstrates very clearly that if Moscow could manifest its opposition to the United States and NATO countries for their intervention in Yugoslavia, it is still in great need of the IMF which has to look after Russia's shaky financial security. Moscow is not alone. Most countries of the world, especially Third World countries, have come to realize that the Bretton Woods institutions have become central not only in their financial and economic development but also in their political internal life. This has a lot to do with the *global governance* and the *dual constituency* syndromes.

2. The 'global governance' syndrome

According to Marie-Claude Smouts (1998), the concept of *global governance* emerged in the late 1980s in a remarkably unmethodical fashion. She adds that far from becoming clearer with use, it currently serves as a catch-all term, sometimes associated with the notion of a regime, sometimes with the concept of global order while it continues to be used by international financial institutions to justify the political conditions they impose on countries which they consider poorly equipped for the proper management of the loans they receive. Governance is then accompanied by a qualified 'good governance'.

Pierre De Senarclens (1998), for his part, states that the end of the Cold War, together with the process of globalization, rocked the structures of international relations. The changes coincided with an acceleration of the move towards regional integration and the collapse of certain countries. Virtually everywhere, they revealed a crisis of national sovereignty and called into question the mechanisms of international regulation.

The notion of governance emerged reflecting as much the demand for a new look at the lines of authority and power as a need to bring up to date the role of new governmental organizations of political and economic regulation (De Senarclens, 1998). The whole issue of governance was then taken over by international organizations seeking to legitimize their predilections and projects. But other factors had to be taken into account: transnational corporations in the world economy, changes in production methods, the rapid

expansion of international trade, advances in information and communications systems and the deregulation of the monetary and financial markets have also affected the evolution of international relations bringing about increasingly close links between the developed countries. At present, we are in a kind of limbo between the world of yesterday (Bretton Woods I) and that of tomorrow (Bretton Woods II).

The classic geopolitical representations of the world arena -the East-West or even North-South divides- are now obsolescent. As the present structures seem unsatisfactory and totally new ones or the establishment of a central World Authority seem out of reach, the idea of good governance was brought forward.

In a study on *Governance and Development*, the World Bank (1992) defined governance as: 'the way in which power is exercised in the management of a country's economic and social resources with a view to development'. The World Bank links it to sound development which it sees as necessitating the introduction of standards and institutions providing a reliable and transparent framework for the conduct of public affairs and requiring those in power to account for their actions.

Governments have a crucial responsibility in this regard. They must ensure that the laws under which the market operates are obeyed, particularly by protecting private property and the security of investments. They must take corrective actions when the market fails to satisfy social expectations. Good governance should involve participation of the non-governmental bodies, notably private firms. Taking these requirements further, the OECD Development Assistance Committee (DAC) has multiplied the number of studies, meetings and recommendations of 'good management of public affairs' which is how it interprets good governance. Extending the World Bank's approach, OECD (1993) defines governance as: 'the use of political authority and exercise of control in society in relation to the management of its resources for social and economic development.'

The public authorities must provide the necessary environment for the economic agents to act in a satisfactory manner. The OECD intends to promote, in poor countries, respect for the rule of law, and sound administrative management and responsible and honest government. Development also encompasses the defence of human rights and the improvement of the education and health of deprived populations. It is up to the OECD countries to link their development aid to the promotion and implementation of this liberal model.

For its part, the Commission on Global Governance (1995) defined the concept as: 'the sum total of the various ways in which individuals and institutions, public or private, manage their own affairs.' It affirms that it is a

continuous process through which diverse or conflicting interests can be brought together in order to find cooperative solutions. Governance requires institutions capable of imposing solutions that are in the general interest and likely to receive wide support. The Commission recognized the role of non-governmental organizations and of the 'civil society' in the struggle for democracy that marked the end of the twentieth century.

There is no doubt that people around the world are involved in a process of rethinking the nature of good governance as well as experimenting more broadly with new ways to collaborate in many areas of common concern. Reference to 'governance' in this context expands the boundaries of discussion and widens the range of alternative arrangements that can be considered when confronting problems not necessarily amenable to solutions by governments acting alone. Briefly said, good global governance is now the catch-all term in most discussions surrounding the establishment of a so-called 'Bretton Woods II'.

Global governance would allow us to link together individuals and institutions at various levels of society (local, regional, national and international) to deal with particular global problems in ways that would not ordinarily be considered when thinking of *global government* rather than *global governance*. But one cannot ignore that efforts to promote democratic institutions within Third World countries depend to a significant extent on the capacity of the international community to resolve broader issues of global governance in an effective manner. Badly or unregulated systems, sharply fluctuating commodity prices, inability to halt rapacious environmental practices or control competitive races to the bottom on the international wage scale do not provide an enabling environment within which institutional reform stands a good chance of success in emerging countries.

The consequences of globalization and the search for a new type of global governance have been many. Several emerging countries have seen a decline in their ability to intervene independently in macroeconomic matters or in the monetary and financial fields. They face capital flows which are always free to go elsewhere in search of a better return. To protect the competitiveness of their economy, they are too often tempted to betray their system of social welfare. In many instances, they also have to accept new limitations to their national sovereignty.

De Senarclens (1998) then continues in wondering which international institutions will take over as national sovereignty declines and as the existing mechanisms of international regulation are deficient. No authority exists to ensure the convergence of the macroeconomic policies of the major economic powers, and the statements, by the G-7 summits which from time to time affirm this intention, usually remain a dead letter. International institutions seem incapable in making a serious contribution towards reducing the critical

problems of unemployment, poverty and marginalization, now a social issue that has taken on a much greater international dimension than in the past.

The shortcomings of the financial institutions of Bretton Woods, are no less significant than those of the United Nations. They have been totally unable to prevent the succession of monetary and financial crises that have arisen. Of course, the Bretton Woods institutions have been mobilized to find answers to the problems and the debt crisis, which threatened to overturn the entire financial system of the OECD countries. They are also playing a part in the transition of the Eastern European countries to the OECD economy. The World Trade Organization (WTO) encouraged this approach by progressively eliminating obstacles that interfere with the full achievement of comparative advantages. Its influence will be determinant in the future and will enhance rather than diminish the *global governance* syndrome in most emerging countries which will, at the same time, continue to be affected by the *dual constituency* syndrome that I will now explain.

3. The 'dual constituency' syndrome

Is it necessary, in a meeting in Santiago, to remind ourselves that Ricardo Lagos, who is a candidate for the Presidency, felt it necessary to campaign in New York and in Washington. Why? Because most leaders of the emerging countries are living in a *dual constituency*. They must now balance the demands of two diametrically opposed groups (Rothkopf, 1999). One group is the voters who will elect the next President of Chile. The other consists of the Bretton Wood institutions and the 30 000 or so traders and fund managers who conduct incessant instant referendums on the policies made by the governments of most countries. A political leader can have broad support at home but can find strong opposition on the part of men and women who vote for their own investments. When investors pull their money out, local economies flounder, policies are derailed and support at home erodes quickly. This happens with dismaying frequency because fund managers are not much interested in the long-term well-being of the countries they judge. What they want to know is whether their money will grow now or in the cycles during which their bonuses are calculated.

It was Wall Street that drove the IMF to focus on making countries creditworthy and preserving the flow of payments to banks and other creditors. Who are those creditors? The citizens of Wall Street (Rothkopf, 1999). This presents emerging countries political candidates, such as Ricardo Lagos, with a problem. He sees the value of sound fiscal policies but he is also aware that these policies may not close the gap between the rich and the poor as quickly as needed and can set back social justice.

This is why many of the poor countries with emerging markets blame the IMF and Wall Street for economic policies that perpetuate the control of a tightly knit domestic elite. These people have been generally the first beneficiaries of globalization and the principal clients of the financial community. They are all for market liberalization until, as we see in many part of the world, it starts to threaten their interests.

The *dual constituency* syndrome represents a fundamental reality for all developing countries. I could take several examples in the Central American States and Venezuela. Billions of dollars were spent in the Central American wars in the 1970s and 1980s. Now it is much more difficult to find the billions needed to support peace and development. The conflicts are over but Central America has essentially returned to conditions of misery and inequality. While El Salvador has experienced steady economic growth, poverty in rural areas remain unchanged. In Nicaragua, the poor are worse off than at the end of the war. Huge debts have kept the region from spending money to fight poverty. Nicaragua, for example, pays 11 times more in debt services than it spends on health care each year. The calls by President Chirac of France and Prime Minister Chrétien of Canada for a moratorium on the debt of the least developed countries take on a real meaning in a region that suffered its worst natural disaster of the century in hurricane Mitch. Local authorities have themselves admitted and the 1998 UNDP Human Development Report on 'Poverty' recognized that the free-market policies and programmes advocated by the IMF and the World Bank have so far mainly served the urban wealthy and the middle class.

In Venezuela, in 1998, every political candidate had to take into consideration the *dual constituency* syndrome. Even Hugo Chávez, the former populist leader who was elected President of the country in December 1998 felt compelled to do a video linkup with Wall Street during the meeting of the IMF and the World Bank, in Washington in the Fall. Speaking to a domestic audience, he had called for a moratorium on paying foreign debts. But speaking via satellite to Wall Street, he said he would actually be more responsible. Chávez later cancelled two trips to New York because he did not yet have a concrete, credible economic plan to offer Wall Street. When he was finally there, he took a very moderate stand.

The backlash against globalization and liberalization, which we are witnessing in Brazil, Russia and Indonesia, to give only three salient examples, is not going to disappear overnight. The Bretton Woods institutions are still going to continue to be at the centre of many criticisms, as we saw at the last Davos conferences and in a series of articles in the *New York Times* in which Mickey Kantor, the former Commerce Secretary, recognized that the emerging countries had been literally pushed too fast in liberalizing their

markets and opening their frontiers. He compared such a policy to building a house and fixing the roof without first building sound foundations.

The Chief Economist of the White House at the beginning of the 1990s, Laura D. Andrea Tyson, adds that Wall Street was then asking for the liberalization of financial markets. The main advocate of such a policy was no other than Robert Rubin, then Vice-President at Goldman Sachs, who was to become Secretary of the Treasury. Jeffrey Marten, now Dean of the Management School at Yale, previously one of the main advisors at the Department of Trade, says that 'we went too far too fast in the process of liberalization in the emerging countries and did it with a certain degree of arrogance'.

The problems that followed, notably in Asia, led the Director of the Davos Forum, in January 1999, to say that he was 'shocked by the mistaken analysis and action of the IMF, that has transformed an endurable crises into a human disaster'.

IMF-bashing has become very popular. One has heard more than once not only George Soros on this matter, but also Eisake Sakakibara, former Vice-Minister of Finance of Japan, and Larry Summers, then Number Two at the US Treasury criticizing 'the blind application of a universal model to every emerging country' and 'the lack of transparency of the IMF and its disfunctionings'.

Everybody seems to recognize that it is necessary to reform the present system. But the fundamental problem is that there is no clear alternative system yet in sight. Moreover, there is no consensus on the real goals to be pursued. After having personally travelled the road that should have led us to a New World Economic Order in the 1970s -most of us remember what happened in Cancun in 1981- and to the reform of the United Nations, on the occasion of its 50th anniversary, I would be tempted to believe that fundamental changes at the IMF and at the World Bank are not for tomorrow, despite the fact that they seem absolutely necessary. Even Michel Camdessus and James Wolfensohn claim openly that the institutions they manage must take more and more into account the social dimension of each country. In an interview, published in *Le Monde*, Wolfensohn (1999) stated: 'I believe that our errors are generated by the fact that we have focussed our analysis and predictions purely on financial criteria. However, it is not possible to be limited to a financial analysis. It is absolutely necessary to take into account the social dimensions of each country'.

Next to hearing such good intentions and to listening, almost every week, to a series of general and very specific proposals for change, beginning with the merger of the World Bank and the IMF, the Bretton Woods institutions' role has been increasing constantly during recent decades, despite the fact that

their original intent and spirit have dramatically changed, since 1971. The architects of Bretton Woods did not expect that private financial flows could one day reach a magnitude that would jeopardize the survival of the original system as such. Since that time, the oil shocks, the debt crisis and the near total breakdown of the economy of several emerging countries have brought forward three basic points:

- (a) That the new global economy could not do without a financial and monetary system of worldwide dimensions.
- (b) That the present system would be maintained as long as a magic formula would create a consensus on how to establish a 'Bretton Woods II'.
- (c) In the meantime, that the search for a new type of global governance will continue to be at the centre of numerous discussions and debates.

4. Conclusions

In conclusion, I would like to emphasize that the rapid degradation of the environment in several Asian, East European and Latin American countries, not to mention the tragic situation in Africa, will necessitate the strengthening of the mechanisms of regulation over the world and hence the restoration of certain controls on the free operation of the market. Governments will therefore have to develop or invent new frameworks and networks, new bounds of solidarity and new forms of sovereignty in contexts that extend beyond those of the nation. I shall certainly see attempts to bring about regulation at regional and international level, which require transfers of sovereignty to supranational bodies or the sharing of sovereignty within regional or international cooperative mechanisms.

So the challenges faced by the world community, especially the emerging countries are formidable. In this regard, being 'lucid' is more important than being either optimistic or pessimistic.

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23. GOING WITH THE FLOW OF THE MARKET

Justin Welby *

In much European thought the concept of responsibility has been devalued in personal ethics almost to a vanishing point, and this is evident also in the financial markets. There are a number of technical and cultural factors that contribute. First, the complexity of the markets, especially in new financial instruments, distances the operators from the consequences of their actions.

An edition of *The Treasurer* (the publication of the UK Association of Corporate Treasurers) in February 1999 showed techniques of managing risk in five new market areas, including weather (admittedly quite useful in the United Kingdom).¹ Technical innovation increases the possibility of risk allocation -or 'risk management', to use a misleading description. All of this sets up a veil between the actor and the consequences of the act in an increasingly distant physical economy.

The proliferation of the number of market centres, competing with each other to introduce new products for trading also all involves the consumption of resources of knowledge, skill and capital and leads to greater possibilities of anomalies and thus arbitrage. Hedge funds have committed huge sums to

* Minister, Church of England. The author is grateful to Professor Caloia, and to participants in the Conference.

1 *The Treasurer*, February 1999.

benefit from these anomalies, operations which essentially add liquidity but not other value to international transactions.² Liquidity is a powerful force which may surge a commodity down or up, to the disruption of the interests of several actors. It is hard to explain to local people why the combination of globalization and a relatively low cost of capital in Asia has caused the shutdown of a manufacturing plant in the depressed north east of England.

Secondly, the development of international markets in mergers and acquisitions, and the possibilities of cross-border operations of this kind within one currency area, which are opened up further by the euro, continue to develop the pressure on company managements to perform in terms that are measured only quantitatively. In the banking sector in Europe there is a trend to seek size both as protection against attack and in order to dominate markets, that is every bit as dramatic as the same fashion in the United States. Companies that fear takeover tend to be less conscious of non-quantitative measures of performance, including social responsibility.

Thirdly, technological change reduces the sense of responsibility. What is closest to us looms largest in our mind and concerns, and this shapes our ethics. The recognition of responsibility diminishes with distance. The dealer in London at a large bank, creating a cocktail of instruments for risk management through the use of several interlinking derivatives markets, does not feel responsible for an increase in the poverty of some coffee growers in Kenya. But his and his colleagues' trading of futures and options, both financial and commodity, may have contributed to dramatic alterations in their well-being. In recent years the inevitable sense of geographical distance has been increased by the use of screen-based trading systems. The reduction of human contact, even if only the intimacy of the trading pit, mechanizes the sense of responsibility. Trading becomes a matter of correct mathematics, a precise but soulless science! This is especially true in the area of new financial instruments, where computer-based trading is the norm. The financial markets have become entities of their own, less and less dependent on underlying physical realities.

There is a great danger of a Luddite³ knee-jerk reaction against change here. Screen-based trading is established, and the open outcry market will not return. Efficient derivatives markets can be of great advantage to all users. However, for that to happen, all those who can gain benefit from better risk allocation (including producer nations) must have equal, informed access to the market, and the dangers must be recognized and mitigated through prudential regulation.

² See comments by Peter Drucker in *Financial Times*, 27 April 1999.

³ The Luddites were a group of workers in 1820s' England who destroyed cotton looms because they feared the loss of employment from the introduction of large-scale manufacturing. The word has become proverbial for an unreasoned opposition to change.

Fourthly, as a result of cultural changes in the wealthiest countries towards consumerism and consumer rights, there is a rise in litigation and expectations. Managements that are not seen as performing in financial terms may not only find themselves the subject of takeover but of attack in the courts. Governments are obliged to regulate financial institutions ever more strictly in order to avoid accusations of indifference towards the national consumer. In all this the interests of the wider community abroad are at best given only lip service. Ask the Financial Services Authority (FSA) (the UK version of the Securities Exchange Commission-SEC) whether as it starts operations its political priorities are with the retail British investor or the African country struggling with vast debts. Or ask a senior manager of a large British bank whether he is more concerned with his reputation in the high street of the towns of Britain or the relief of poverty and the answer, taking away the inevitable confusion, will be the local over the distant.

Fifthly, the same cultural changes in the wealthiest countries mean that voters are increasingly tolerant of the marginalization of large sectors of their own populations, let alone those overseas. Although the rhetoric of compassion rises, the execution of such principles reduces. Charitable giving in the UK has fallen 31% in the last five years, with the greatest fall among the young.⁴ Consumerism makes self-fulfilment by material means the highest value, and the deferral of pleasure for the sake of others an almost incomprehensible idea.

Set against all this is the fact that most financial participants wish to feel that they are 'ethical'; but what that means is usually driven by the general culture more than by a process of rational enquiry and action. Ethics is also individualized; if *I* am doing right then what the institution is doing is somebody else's responsibility. Or nobody's, the way things are.

An overall settlement of financial structures that runs against the grain of the culture, technology and technical innovation in the financial markets will not succeed. For example, in another social area the failure of prohibition in the United States in the 1920s was owing to the complete lack of any sense that it was a good thing. Effective ethical development begins with a sense of what should be and crystallizes it in values and written codes. In the United Kingdom the law against insider dealing arose out of a widespread sense that it was wrong and to be condemned.

In other words a simply deontological approach cannot succeed unless it arises out of a common acceptance of certain virtues that are themselves of *genuinely global acceptance*. Put as baldly as that the task is ridiculous, utopian and the ravings of a

4 *The Economist*, 28 March 1999.

well-meaning but ineffective English clergyman! But in application I suggest that there are existing tools that can be effective, both technical and cultural.

Globalization of the financial markets is a process that has huge support among financial professionals. Attempts to reverse or inhibit the process are not likely to succeed in the absence of a profound external shock, which is of course possible but would bring its own great suffering.

However, globalization is a very selective process, and non-selection carries with it as much problem as inclusion. Inclusion is as important as justice and peace. This is especially true when countries have involvement in the international market for physical trade and commodity production, but limited or no access to global financial markets or expertise in their use. If we read the chapters of this book, how often do we read the words 'Asia', 'Latin America' and 'Eastern Europe'? In almost every section. And how often the word 'Africa'? Perhaps twice. If the international financial system is to function well there must be procedures to reintroduce those countries or areas that are excluded.

My main suggestion is that any approach has to create institutions that are seen as on the side of the financial markets but that inhibit the sense of distance and unquantifiable irresponsibility that are so pervasive at present. In other words there must be built in the objectives of justice, peace and inclusion, but so that they are the foundations, not necessarily the visible structure. They must also be of wide acceptance to market participants and, of equal importance, must respect the sovereignty of national entities. This last point is critical, lest they be seen justifiably as a Trojan horse for a new economic and financial imperialism. On these foundations should be built structures that command acceptance from their link to widely held values of financial markets and good governance. There are many aspects to this. All are based on virtues that spring not just from the Judaeo-Christian tradition but much wider. The following are merely examples.

1. Prudence

First, prudence. One aspect of financial prudence is the control of liquidity, a technical question. The biggest inhibitor of over trading and of volatile markets is the requirement to set aside reserves on a large scale. This increases transaction costs and forces a slowing of reactions to market movement. Although the development of globalized financial instruments has potential benefits in terms of risk management they are also the carriers of high risk through transaction exposure to larger numbers of counterparties, settlement problems and the difficulty of dealing across time zones and in different cultures. All these factors justify high reserves, which would incidentally act

as a damper on the movements of prices. Effective international structures should include powers to set reserve levels in different markets which could be increased at times of high volatility (which is now measured as part of derivatives trading),⁵ and thus risk. Prudence is a virtue in the financial industry, but its demands must be global to avoid competitive deregulation. There is ample precedent for a fixed prudential regime in the standards set for primary capital by what was known as the Cook Committee in the late 1980s. Much work of great value in this area is being done by the BIS, but needs political support and rapidity of response to cope with changing market circumstances.

The sophistication of new financial products can easily circumvent the efforts of a single government or national regulatory authority to manage market turbulence. Much has been rightly made in this book of the success of the Chilean model, including the successful control of inflows of investment in the early to mid-1990s. However, an investor in Chilean commodities or equities need not come near the country. It is possible to create a synthetic market in Chilean shares based on an index in Santiago, but traded as a derivative elsewhere. Although at first sight this would have little impact on the real economy of Chile, over time, if the contract were widely held, sharp movements in its value would be likely to have a knock-on effect.

Prudence also demands that complexity of this sort is managed, and innovation in financial products directed, but not banned. The new architecture, or the major financial regulatory agencies, need to be able to insist on the proper management of new financial instruments and their trading. This fits in with the most recent approach to regulatory supervision which is based as much on qualitative assessment of controls, managements and systems as mere quantitative measures. Although legal action on a universal basis is practically impossible or terminally lengthy to achieve, authorization to deal can be limited. For example, recognized instruments and dealers in them can be limited by the cooperation of a relatively small number of regulators. Pension funds and other major users of markets would be expected only to deal with those who had been recognized as capable of managing market making properly, who had a sort of 5 Star rating. In this way responsibility is increased.

5 Trading in an option contract is essentially the taking of a view partly on the future price of the underlying commodity, but more importantly on the speed of movement of the price of that commodity during its life

2. Transparency

A second key virtue is transparency. Globalization of markets brings obscurity, which leads to injustice. Structures of governance need to be able to ensure transparency and thus *fair* pricing of transactions.

For example, transparency demands that the full cost to the community of decisions on investment nationally and internationally, including by way of merger or acquisition, are recognized. The purchase of a company in England by one from Spain can result in the closure of operations in Latin America where there is an overlap of interests. This effectively exports the cost of the rationalization from Europe to the local economy. Institutions must be able to look through corporate or national boundaries to ensure that such operations result in the real cost being born by those who will benefit, the shareholders of the entities concerned. Risk and reward must be kept together. Trading advantage through fiscal or regulatory anomaly is a legitimate target.

3. Responsibility

Thirdly, facing responsibilities honestly is a key virtue for effective national financial markets. This can be recognized in a number of ways, two of which are issues of insolvency on a global basis, and penalties for irresponsible behaviour. Neither of these diminish the primary legal and fiduciary responsibility of the financial actor to depositor, investor or beneficiary.

In national markets such as the United Kingdom, insolvency law has a number of principles. Among them are the equal treatment of creditors, the priority of certain forms of payment such as tax and social security and that the process should be brought to a clear conclusion. These are noticeably absent in cases of sovereign debt and illiquidity. In particular, countries may find themselves burdened forever, with no natural way out of unpayable debt except through withdrawal from international markets, at great cost to future development. A new international architecture must have the means to manage such issues, including ethical principles of certain areas of a nation's life being protected from the effects of debt payment, or prioritised as in US Chapter 11 insolvency or UK administration. These must include health, education and other social costs that are critical to the nation's life. The benefits of certainty should encourage participation by responsible financial institutions.

The recognition of social cost on an international basis is very difficult but is critical in reducing the sense of distance that I have referred to. The concept of *social audit* is one that has growing recognition in a number of areas, especially among extractive industries. However, it tends to be limited to

positive actions of social contribution or environmental protection that are separate from the effects of markets. Institutions that are involved in managing global markets need to have the capacity to produce credible research that faces financial actors with the measurable cost of what they do. This is a long-term but essential means of combating the culture of distance and irresponsibility.

Space and time have not permitted a detailed analysis. But the core of my argument is this. Technical, technological and cultural factors diminish or render ineffective the sense of responsibility that should properly be had by the great financial institutions of the world. Globalization is an accepted fact, and codes or rules will not change attitudes and aspirations of the players in the market. New institutions must work with the grain of the markets, with their flow, using the basis of agreed values and virtues on which to build an ethical structure.

CONCLUSIONS

24. THE EMERGING ECONOMIES IN THE GLOBAL FINANCIAL MARKET: SOME CONCLUDING REMARKS

*Carlo Pietrobelli and Stefano Zamagni **

Here we do not aim at carefully surveying all the chapters of this book, rather we will single out the most prominent elements that have emerged from the extensive research and discussion that is behind the volume, and try to derive some implications both for future research and for a tentative policy agenda.

1. The global economic order

The emergence of a global economic order has come to represent the most characteristic feature of our age. Globalization entails many dimensions, but it is a fact that the creation of a global financial market constitutes the most relevant one. The increasing importance of the financial structure with respect to the real side of the economy is posing a novel paradox. At a time when we need more regulation, just because financial markets are intrinsically unstable, we have less, since international financial institutions are weaker, in relative terms, than the domestic ones, or even non-existent. As we are reminded by Charles Kindleberger (1996): 'If there is no authority to halt the

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disintermediation that comes with panics, with forced sales of commodities, securities, and other assets, ... the fallacy of composition takes command. Each participant in the market, in trying to save himself, helps ruin all.'

An important implication of the paradox noted above is revealed by the recent financial crises which have shown a peculiar nature, reflecting one novel feature of international capital flows. In fact, the recent emerging market financial collapse has been largely a private sector problem of excessive lending by private banks and non-bank financial intermediaries (NBFIs) in developed countries to private banks and corporations in developing countries. Therefore, it is not an issue of sovereign borrowing as such, as it was the case in the 1970s, and thus it is not really suitable for intervention by the intergovernmental IMF for fiscal remedies (Fitzgerald, 1998). Financial crises will continue to come in different flavours. Some countries will continue to experience old-fashioned balance of payments crises as a result of permissive domestic monetary and fiscal policies incompatible with their exchange rate commitments. However, other countries will experience new 'high-tech' crises (Eichengreen, 1999), driven by the interplay of domestic financial sector weaknesses (such as financial repression) and international capital flows. Macroeconomic imbalances may play a part in the latter type of crises, but not a leading one, with private agents' decisions and in general financial factors remarkably amplifying the consequences, and sometimes causing the crisis. A third category corresponds to macroeconomic disequilibria led by capital surges. These disequilibria were at the heart of the 'tequila crisis', and to some extent of the East Asian difficulties. The generalized downward adjustment experienced by Latin America in 1998-99 is also associated with a capital surge in 1996-97 (Ffrench-Davis, 2000).

2. Benefits and costs of international capital flows

Notwithstanding these worries, we should not underestimate the potential positive contribution of foreign capital, and of the further integration of international capital markets, to emerging countries' growth. This deepening of integration may have two major effects:

- promote a better *allocative efficiency* -that is, a more efficient international, inter-temporal and inter-sectoral allocation of resources
- break the possible constraint (i.e. upper limit) to a country's investment imposed by the insufficient level of *domestic savings*.

However, the globalization of capital markets also implies a trade-off between these potential benefits and the short-term instability that may be generated -as, for example, a possible sudden inflow or outflow that may

hinder a smooth development process. While the high costs of reversals of short-term international capital flows are evident, the benefits are less clear. This is in sharp contrast with foreign direct investments (FDI) and trade flows, where the very large developmental benefits clearly outweigh the costs (Griffith-Jones, 2000).

Moreover, international capital flows also constrain national choices over monetary and fiscal policies, and this constraint has been vividly portrayed as the open-economy *trilemma*: a country cannot simultaneously maintain fixed exchange rates, open capital market, and pursue a monetary policy oriented towards domestic objectives (Obstfeld, 1998).

Importantly, the benefits of the opening to foreign capital inflows are conditional on their being employed to increase the domestic investment rate. Manzocchi (1999) provides interesting evidence that this condition was not fulfilled in most countries of Africa and Latin America for much of the 1970s and early 1980s. In contrast, Asian countries did not increase private and public consumption to decrease productive investments. French-Davis (2000) presents similar evidence of the slower growth of investment than capital inflows in Latin America in the 1990s.

Foreign finance also brings additional advantages (Obstfeld, 1998; Manzocchi, 1999) as it (i) loosens liquidity constraints in times of stringent liquidity needs, (ii) allows an inter-temporal reallocation of consumption and savings that may be more adequate and conducive to higher growth rates, (iii) spurs local financial institutions to become more efficient and (iv) disciplines policy-makers who might be tempted to exploit a captive domestic capital market: their unsound policies would spark speculative capital outflows and higher domestic interest rates.

In such a situation, we need to stress a pragmatic remark: globalization of financial activities is still involving only a small number of developing countries. Throughout the 1990s, the low-income nations, where 41% of the population of developing countries live, have attracted only 6% of private capital flows to the developing world (Ocampo, 1999).

Therefore, insofar as most countries in the world live in an environment characterized by very low domestic saving rates and very low capital inflows, the benefits from foreign funding to these markets are likely to outweigh the damage for such countries. In addition, it is increasingly realized that growing international capital mobility is largely inevitable and irreversible. Then, we cannot but agree with Barry Eichengreen (1999) that 'the problem for policy is to ensure that the benefits of capital mobility exceed its costs rather than pretending that it can be made to go away'.

3. Capital mobility and crises prevention

Capital mobility is likely to increase in the near future, together with the volatility of the exchange rate of the three major currencies (the dollar, the euro and the yen). In fact, innovations in electronic communications and money transfers, combined with the abolition of capital controls, have resulted in financial capital moving in response even to the smallest difference in cross-country interest rates and perceived future rates of return. Hence the risk of financial instability due not only to greater speculative activities and attitudes on the part of agents, but also to herd behaviour which is rooted in maximizing behaviour (Palley, 1995). The technical complexity of several of the new financial instruments has risen substantially, widening the range of options available (Blommestein, 2000). The potential for boom–bust episodes of large capital inflows to emerging countries, followed by larger reversals and capital outflows is not likely to disappear (Swoboda, 1999 and 2000). Thus, it is necessary to learn how to deal with crises: the best option is clearly to prevent them.

The focus of host countries' policy-making should be the management of the booms, as the crises are often the consequence of badly managed booms (ECLAC, 1999, Ocampo, 2000). This has been shown by the experience of countries like Colombia in the 1970s and Chile since 1991, and represents a strong case for the design and adoption of an appropriate domestic regulatory framework, and of prudential macroeconomic policies. An example in point is the cautious management of capital inflows that Chile has been choosing since 1991, with reserve requirements to discourage short-term inflows and preference given to foreign direct investments (FDI) and long-term inflows.¹ Another example is Malaysia, which introduced a tax upon short-term capital outflows without jeopardizing FDI. The microeconomic costs associated with the use of such instruments should be weighed against the social benefits of macroeconomic stability, investment and growth (Ffrench-Davis, 2000). In general, it can be said that this type of measures not only reduce the incentive for destabilizing speculation, but also helps restore domestic policy autonomy. Indeed, it should be recalled that speculative attacks and herd behaviour create major negative externalities upsetting the incentive scheme on the basis of which agents make their choices, the result being that, as happens with any other externality, private decision-makers do not take into consideration in their calculations the social risk associated to their own behaviour. This is why some form of public intervention is required.

1 Also following these policies, FDI in Chile represented 35 per cent of total capital inflows in 1990, and they rose to 64 per cent in 1997 (Massad, 2000). See Reisen (1999) for a more moderate view on the effectiveness of these policies.

4. Resolution of currency and financial crises

However, in the event a crisis exploded, automatism agreed *ex ante* to handle crisis situations may increase the confidence in the system -without introducing excessive rigidities- crises always existed and will always exist, and the next one will be different from the previous one, and unexpected (Swoboda, 2000).

A strong case has to be made for more effective monitoring and regulation of the asset and liability structures of financial institutions. It has been shown that when foreign investors can allocate their wealth over many risky foreign investments, and face a fixed cost of information about each country, it may pay for individuals to diversify widely without bothering to get this information. The consequence is that capital flows can be volatile and subject to herding effects (Calvo and Mendoza, 1997). Consistently with this line of reasoning, the IMF has been rightly pressing countries to improve and broaden their disclosure of economic data. However, although more and better information is needed, it is not at all clear that lack of information was the problem in several crises, and furthermore information availability is not enough by itself, as it is intrinsically asymmetric, not to mention the fact that the relevant issue is how people in the market process information.

How to achieve an orderly resolution of currency and financial crises? In Chapter 8 of this volume Griffith-Jones usefully reviews and discusses a number of arrangements that might facilitate the orderly resolution of debt crises, such as the proposal of introducing the possibility of changing the contractual provisions of sovereign debt, the creation of internationally sanctioned standstill provisions and, in general an enhanced framework for future crisis management. A special attention has to be paid to *transition periods*. In fact, while it is true that financial liberalization, by enhancing efficiency, is ultimately beneficial, it is also true that it often brings problems in the transition period, especially due to risks of contagion *ex ante*. In the light of this, the decision of the IMF to create a new Contingent Credit Line (CCL), providing up-front assurance of Fund support, might prove to be appropriate, even though its mechanics needs to be revised.

5. Foreign debt composition

Substantial evidence has been provided to conclude that an emerging economy should not be indifferent to the composition of foreign debt: rather, careful attention should be paid to it. The capital surges (i.e. sudden deviations from the trend of capital inflows and outflows) tend to raise consumption, because of the faster capacity of consumers to react as compared to irreversible productive investment (French-Davis, 2000). In

contrast, FDI as well as long-term loans to importers of capital goods contribute to capital formation. Thus, *ceteris paribus*, long-term debt is preferable, as it is more likely related to productive investment, and therefore concerned with the future economic conditions of the country. However, some authors have noticed how difficult it is to determine in practice whether certain capital flows are direct investments or short-term in nature, and that also short-term inflows may be complementary to, and facilitate the financing of trade and of foreign investment operations (Blommestein, 2000). Nevertheless, the fungibility of long-term resources is smaller, and foreign resources may go into current consumption rather than into productive investments to a smaller extent, taking due account of the problems of debt overhang, when foreign debt may anyway end up lowering investment (Krugman, 1988).

6. International financial architecture

Although capital and goods markets are increasingly integrated, policy-making has largely remained a national matter. Most authors claim the relevance of institutions in the new global financial environment. The May 1998 G-7 decision to introduce a new global financial architecture can be seen as a first step in the direction of re-regulating the international monetary system. Indeed, the conditions under which institutions such as the World Bank and the IMF were founded are no longer with us. There are structural flaws in the present-day system, which was conceived for the western world (and not for developing countries) to assist in adjustment of current account imbalances. Yet, there are too many different ideas on what institutions should be in place, what they should do and how. The frequency and magnitude of major disturbances such as the international financial crises reflect the tremendous asymmetry existing between an increasingly sophisticated, yet unstable, international financial system, and the institutions that regulate it. The world lacks the types of institutions that financial globalization requires (Ocampo, 2000). The case for the provision of emergency lending by the international financial community, eventually by the International Monetary Fund (IMF), can be strongly made on theoretical grounds. More generally, a world in which large nations gear their macroeconomic policies to internal goals (and can afford to do so) and markets are integrated generates *externalities* for third countries, especially smaller developing economies. It is crucial that international economic organizations, international financial institutions (IFIs) in particular, play a leading role in internalizing the positive externalities and in mitigating the negative ones (Swoboda, 2000).

A pragmatic contradiction should already be noted at this stage. As Saccomanni (1999) correctly points out, the proposals so far put forward for a new international financial architecture, while assigning to the G-7 a major role in the steering of the monetary system, do not contemplate any form of policy coordination -not to mention cooperative behaviour- among the G-7 themselves. Yet, it cannot be denied that the international repercussions of the domestic policies of the seven largest countries are a major determinant of financial stability.

7. Conditionality and ownership

The balance between conditionality vs. 'ownership' of policies affects the national economic and social development strategies and institutions. A controversial issue behind international capital flows is 'conditionality'. It has been forcefully argued that conditionality should not extend to questions relating to economic and social development institutions and strategies, which fall within the purview of other international organizations and especially of legitimate national authorities (Feldstein, 1998; Griffith-Jones, 2000; Ocampo, 2000; Rodrik, 1999; United Nations, 1999). The IMF has often applied conditionality beyond what is perceived to be necessary for the Fund to perform its role properly; instead, conditionality should apply only to macroeconomic policies, but not to structural measures, and no conditionality should apply when the crisis is due to totally external factors.

In all cases, a broad-based consensus on the extent and limits of the conditionality of IMF lending should be reached, with developing countries equitably represented where decisions affecting the global financial system are made. 'Giving the developing world (that is, 85% of humanity) a serious role in shaping the new global institutions is the surest way to achieve that end' (Sachs, 1998). Moreover, developing countries should retain the 'ownership' of the policies affecting the national economic and social development strategies and institutions. In the light of this, the transition initiated by the IMF from an ESAF (Enhanced Structural Adjustment Facility) approach to a PRGF (Poverty Reduction Growth Facility) approach should be looked with great interest. It is not simply a question of semantics: poverty reduction is now gaining the forefront, after a generalized awareness that growth *per se* does not guarantee the reduction of inequalities. Within this context, interesting proposals concerning the increased role that regional and sub-regional financial institutions and financial cooperation mechanisms should play have been put forward. Thus, supervision, crisis management and conditionality would be handled at the regional level, by regional organizations such as Mercosur, ASEAN or the SADC, that would put peer pressure on their members rather than Washington pressure (Sachs, 1998;

Ocampo, 2000).² Moreover, the integration of capital markets has remarkable implications also for the governance of domestic policies and on the constituencies of national governments. In fact, most leaders in emerging countries are living a '*dual constituency syndrome*': on the one hand they are elected by their countries' voters, but on the other they also need the support of the men and women who vote for their investments. If investors pull their money out, local economies flounder, policies are derailed and support at home erodes quickly. To this aim, constant support from international (and mainly Bretton Woods) institutions is badly needed (Sabourin, 2000).

8. Taxation and technology

The globalization of financial markets and its effects should be regarded together with other dimensions of globalization that are related to it but often disregarded or analyzed separately. Thus, because taxation is often an essential ingredient of government policies aimed at protecting the most vulnerable in society -or, at least, at promoting social policies- the new architecture of the international financial and economic system must not ignore the impact of globalization on tax systems. Most developed countries have entered into bilateral tax agreements among themselves, but not with many developing countries. This state of affairs is certainly detrimental to developing countries, since it favours wasteful tax competition among them in order to attract foreign investors. Only a multilateral tax agreement would avoid these serious shortcomings (Stiglitz, 1998). These issues have been remarkably absent in the recent G-7 Finance Ministers' and Central Bank Governors' communiqués, and in general in the policy debate. However, several proposals have been put forward by academic economists and policy-makers, including the creation of a World Tax Organization, to make tax systems more consistent with the public interest at the world level rather than the public interest of specific countries (Fitzgerald, 1998; Tanzi, 2000), and policies to protect the most vulnerable in society, or the equity and financing of international public goods (e.g. peace, good and more equitable environment, absence of extreme poverty). This is all necessary in order to develop an international financial architecture 'with a human face' (Tanzi, 2000). The dilemma of increasing material benefits owing to globalization and the unsatisfactory results for society's vulnerable groups, inequality, uncertainty, and social disintegration calls for a humanistic vision (Aninat, 2000). To this regard, one is reminded by James Wolfensohn that what is needed is a holistic approach: 'We must consider the financial, the

2 This would resemble the mechanism that underlay the most successful aid programme in history, the Marshall Plan: Europeans had to work out the details of aid allocation, they watched at each other, financed collective infrastructures and built and deepened regional cooperation institutions. (Sachs, 1998, p.5).

institutional and the social, together. We must learn to have a debate where mathematics will not dominate humanity, where the need for often drastic change can be balanced with protecting the interests of the poor. Only then will we bring the international financial community and local citizens with us' (Wolfensohn, 1998).

The debate is going on about these issues. It has been argued that international financial integration has the desirable effect of inducing tax competition, and the expected outcome of lower capital taxes may encourage long-term investments and higher living standards (Obstfeld, 1998). However, the following necessary rise in the tax burden on labour might reach excessive levels, and generate a popular backlash against free trade (Rodrik, 1997). The empirical balance on these issues is hard to strike, but the latter case is likely to be more frequent.

Another dimension of globalization refers to the globalization of technology, that is often considered a separate issue and that is often taken for granted. In fact, technology is becoming internationally easily accessible only to a limited extent, and emerging countries appear to be still very marginal and excluded by the 'feast' of technology and innovation occurring at the centre of the system, and to a larger extent than for capital flows (Archibugi and Pietrobelli, 1999). Thus, the developing countries that are participating to international capital flows also often have negligible access to advanced technologies developed elsewhere.

9. Transparency and governance

The increasing complexity and globality of the system is raising the distance between decision-makers, financial agents and the agents bearing the consequences (Welby, 2000). A consequence of globalization has been that experts of micro-finance have become determinant for the evolution of the countries' macroeconomy (Ffrench-Davis, 2000). To this end, the transparency of the social costs involved in any economic decision must be increased and become easily accessible and understandable. Moreover, also the proposers of a new international financial architecture (be they academics, governments and policy-makers, or groups from the civil society) should become more concerned about the trade-offs involved in each choice. A good economic system still needs to reward productivity improvements more than speculation and mere luck, and the consequences of policy options must be clearly stated and understood.

This point raises a more general issue. Just because globalization is a phenomenon qualitatively different from interdependence -which has essentially to do with interactions among nation states- what we need is a new

approach towards governance that go beyond the mere sum of nation-states and multilateral cooperation (Caloia, 2000). As stressed by Reineke and Wittle (1999), it is necessary to think in terms of global governance instead of more inter-state cooperation and domestic politics. To this end, a '*third pillar*' is needed, the one represented by those transnational private actors such as Non-Governmental Organizations (NGOs) and associations of various kinds that cut across national boundaries. It would be utopic to pretend to cope with the challenges of globalization forgetting those expressions of transnational civil society such as NGOs. Basically, the reason is that today the economy has become global while politics has not. This has removed the stable linkage between the State, the territory and wealth, resulting in fact in 'wealth without nations'. The domestic agendas of the institutions that wield authority in the nation-states are becoming increasingly constrained by interdependence, and the margins of freedom in public choices are being drastically reduced. The result is that, faced with increasing economic powers, the (more or less gentle) Leviathans see their shares of sovereignty gradually being whittled away. This is why we think that there will be no future for a neo-Statist approach, which pretends to reinstate nation-states with the operational authority they used to have, or for a neo-liberal approach, which pretends that the economic game can be played at no risk without any kind of political control. The strategy we favour is the one which aims at empowering civil society and its multifarious expressions operating at the transnational level (Bernard, Helnich and Lehning, 1998).

10. Conclusions

To sum up, the main message we want to convey is twofold. First, it is by now a well recognized fact that market systems are consistent with many cultures, conceived as tractable patterns of behaviour -or, more generally, as ways of life. In turn, the type and degree of congruence of market systems with cultures is not without effects on the overall efficiency of the systems themselves: in general, the final outcome of market coordination will vary from culture to culture. Thus one should expect that a culture of extreme individualism will produce different results from a culture where individuals, although motivated also by self-interest, entertain a sense of solidarity. In the same way, a culture of peace and harmony will certainly produce different results, on the economic front, from a culture of confrontational competition.

But cultures are not to be taken for granted. Cultures respond to the investment of resources in cultural patterns, and in many circumstances it may be socially beneficial to engage in cultural engineering. Indeed, how good the performance of an economic system is depends also on whether

certain conceptions and ways of life have achieved dominance. Contrary to what many economists continue to believe, economic phenomena have a primary interpersonal dimension. Individual behaviours are embedded in a pre-existing network of social relations which cannot be thought as a mere constraint; rather, they are one of the driving factors that prompt individual goals and motivations. People's aspirations are deeply conditioned by the conventional wisdom about what makes life worth living.

What the intense debate which took place during the Conference made clear was the urgency of a *new organizing principle* within economics, capable of enlarging the scope of economic research in order to make it more relevant for the analysis both of policy means and of policy ends. As it is well known, during the nineteenth century, mainstream economic theory argued for the divorce of economic judgement from moral and political philosophy. This divorce was supported by the idea that economics should only be concerned with means and not with ends, which has rendered the discipline of little use for the understanding of social processes and for the analysis of structural change. What is called for today is a theoretical set-up by means of which one can explain how cultural factors and economic choices interact and how this interaction feeds back into the ongoing social relations. The underlying idea here is that of coevolutionary dynamics: individual behaviours and social norms evolve jointly as micro and macro changes in the latter prompt adjustments in the former and vice versa (Zamagni, 2000). This is clearly a very complex and far-reaching scientific endeavour, which the most recent economic literature has just began to explore, and which can help us to answer fundamental questions of the following type: Is finance any different from any other economic activity and if so in which sense? If one defines a financial asset as a bundle of property rights, what ultimately justifies those property rights? Certainly not labour, but if so, what else? The financierization of the economy is creating the anthropology of *homo finantarius* as a subspecies of *homo oeconomicus*. However, what can be said about the moral standing of financial markets and the inner logic of its institutions?

The second message is to call attention to a most startling paradox characterizing the present phase in international financial relations: in spite of the apparent atomization of post-industrial economies, this epoch needs more, not less, collective decision processes; more, and not less, cooperative efforts. Indeed, as the new political economy has convincingly demonstrated, at the bottom of each market failure we find the market inability to produce cooperative results, which in turn are the effect of the presence within the economic system of significant and solid networks of trust. In a well known essay, Arrow (1972) writes: 'One can plausibly maintain that most of the world's backwardness can be explained by the lack of mutual trust.' The reasoning underlying this proposition is simply that development demands high levels of cooperation and the latter, in turn, implies deep trust ties among

economic agents. The strong connection between trust and development opportunities has been ascertained at the empirical level too. Suffice here to mention Robert Putnam's accurate research updating results obtained by Harvard politologists (Putnam, 1993), and the conclusions reached by Knack and Keefer (1995), on behalf of the World Bank, on the connection between the degree of trust in personal relations and private investment. As expected, these authors find that most countries with an above-average level of trust also present higher levels of investments. One can safely say that the market is an institution resting essentially upon trust, which means that trust must already be in existence before a market economy can start its functioning. In all societies an informal network evolves to structure interpersonal relations. The fabric of this framework is essentially made up of relations of trust which, in a sense, provides a sort of common language for encoding and interpreting information for the agents.

If so, the following question needs to be raised: which conditions should be met for an economic system to generate and improve trust relations? It is the case that civil society is the privileged locus where trust inclinations are fostered; not so much the market itself which is rather a 'trust-consumer', not a 'trust-producer'. Indeed, the two fundamental elements of trust -mutual acknowledgement of identities and engagement not to cheat nor betray even when it is feasible at no cost- cannot be generated via a reputational mechanism, since they must be offered initially as 'free gifts' by the agents involved when the market process starts. If this were not so, people would never enter agreements that are not fully enforceable. It may be of interest to report the following passage from an interview with Peter Drucker:

Above all, we are learning very fast that the belief that the free market is all it takes to have a functioning society -or even a functioning economy- is pure delusion. Unless there's first a functioning civil society, the market can produce economic results for a very short time -maybe three or five years. For anything beyond these five years a functioning civil society -based on organizations like churches, independent universities, or peasant cooperatives- is needed for the market to function in its economic role, let alone its social role. (*Ottawa Citizen*, 31 December 1996).

This is why it is conceptually misleading and practically unproductive to reduce trust (which is a *relation* between agents) to reputation (which is an *asset*), since it would prevent economic research from inquiring about the strategies to be followed in order to reach that critical threshold of generalized trust among agents beyond which the market can subsequently act both as a reputation control and as a reputation enhancing device.

The specific nature of the 'tragedy' of transition economies -think of the case of Russia- lies in the following disquieting paradox: in spite of the fact that it is in everybody's interest that transition to a market-type society is

obtained, the cultural matrix prevailing in society and the nature of social dynamics of individual behaviours might be such that multiple equilibria exist that can take the economy in many directions, including decline. In view of this, we cannot but fully agree with North (1997):

If the institutional matrices of economies did not result in path dependence ... and if instrumental rationality characterized the way choices were made, then institutions would not matter, and overnight the policy maker could impose efficient rules upon an economy and overnight alter its directions to a productive economy. Such, in essence, are the problems of transition economies.

There is no doubt that the fact that modern economics stubbornly continues to forget about the social acceptability (i.e. the justice dimension) of market outcomes bears a certain responsibility in the generation of those perverse results which we observe in many Third World or transition economies.

We do not wish to hide the difficulties lurking in the practical implementation of a cultural project targeted at nothing less than a 'paradigm shift' in economic analysis. As in all human endeavours, it would be naive to imagine that certain changes do not create conflict. The differences of vision and the interests at stake are enormous. It is no accident that a kind of widespread anguish about the future is running throughout society today. Some people and certain pressure groups are exploiting this anguish as a political tool, deriving from it, depending upon the circumstances, either a market-centred Machievellianism or a State-centred Machievellianism. It is precisely against this neo-Machievellian culture that the International Jacques Maritain Institute as well as all those who believe in the values of human dignity and economic democracy have to battle today. We are confident that this can be done successfully if one accepts, as a guiding principle, what Boyer (1996) has called the 'scholarship of engagement': moral commitment and cognitive interest should remain intertwined and reciprocally combined.

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