5. A BROAD AGENDA FOR INTERNATIONAL FINANCIAL REFORM

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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

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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 architecture[2]) to include those associated with development finance and the 'ownership' of economic and, particularly, development policies; secondly, it should consider, in a systematic fashion, not only the role of world institutions, but also of regional arrangements and the areas where national autonomy should be maintained. This is the focus of this 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
Porfolio 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 (excluiding 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*, Washigton, D.C., March 1999 and *World Economic Indicators*, Washigton, 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 resolution[6]

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

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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.

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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.

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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

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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

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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.

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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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