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

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

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 if 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.

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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.

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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.