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John Williamson
and others

The Pursuit of Reform

Global Finance and the Developing Countries

Edited by
Jan Joost Teunissen

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The Pursuit of Reform: Global Finance and the Developing Countries

Proceedings of the Conference on the Functioning of the International Monetary System and Financing of Development, held at the Netherlands Ministry of Foreign Affairs in The Hague on 21-22 June 1993, organised by the Forum on Debt and Development.

Editor: Jan Joost Teunissen

The views expressed in this book do not necessarily represent those of the Forum on Debt and Development. Summaries of the floor discussions following the papers attempt to convey the sense and substance of what was discussed. They have not been reviewed by the authors, the discussants, or the participants concerned.

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Forum on Debt and Development (FONDAD)

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Abbreviations

ADR	American Depository Receipts
BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
CCFF	Compensatory and Contingency Financing Facility
CAD	Capital Adequacy of Investment Firms and Credit Institutions
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
DC	Developed Countries
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECLAC	Economic Commission for Latin America and the Caribbean
EEC	European Economic Community
EMS	European Monetary System
ERM	Exchange Rate Mechanism
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDR	Global Depository Receipts
GDP	Gross Domestic Product
GEF	Global Environmental Fund
GNP	Gross National Product
GSP	Generalised System of Preferences
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
IMS	International Monetary System
IOSCO	International Organisation of Securities' Commissions
LDC	Less Developed Country
LIBOR	London Inter-Bank Offer Rate
NAFTA	North American Free Trade Agreement
NIEO	New International Economic Order
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
OOF	Other Official Financing
SAF	Structural Adjustment Facility
SDR	Special Drawing Right
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNCED	United Nations Conference on Environment and Development
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund

Preface

Against the background of the daily reports on the dynamic developments taking place in the world economy, FONDAD invited, for the second time, a group of eminent scholars and policymakers to discuss the functioning of the international monetary and financial system – with particular reference to the developing world and Eastern Europe. "The Pursuit of Reform: Global Finance and the Developing Countries" reflects the discussion which was held by this group of experts at a conference in The Hague in June 1993, and involved participants from industrialised as well as developing countries.

In the introduction of the book that resulted from a previous meeting organised by FONDAD in 1992, "Fragile Finance: Rethinking the International Monetary System", I noted that it is much harder to reach consensus on the successes and failures of today's system – let alone agree on the reforms required – than it is on the system of the past. The analyses and discussions presented in this volume are, once again, no exception to that rule.

Nonetheless, it was widely agreed during this year's conference that there are many areas in which the international monetary system is not functioning properly and must be improved. And while present political circumstances do not seem to favour fundamental reform, the opinion was also voiced that intellectual pressure on governments should be maintained with a view to implementing reforms which would move the system in the right direction. "A pervasive feature of the 1990s," said the Dutch Minister for Development Cooperation Jan Pronk in his opening address, "is the lack of order and, therefore, lack of stability in international relations".

Most experts agreed that one of the major priorities of the present international monetary system is to make it genuinely rule-based, with all countries – minor and major – accepting the burdens of fiscal and monetary adjustment equitably. A number of experts felt strongly that efforts at international cooperation and policy coordination should be more focused at taking the developing world fully into account, rather than treating it as a footnote. They made the point that the developing world accounts for 80 per cent of the world's population, 70 per cent of its surface area, and a much larger share of the world's physical output than traditional GNP figures generally reflect.

Various experts stressed that the debt crisis, contrary to growing popular opinion, is not over. While a number of the larger Latin American countries are emerging from a state of debt distress and regaining access to capital markets, the foreign debt problem still remains extremely serious for over

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sixty countries in Africa, Central America and the Caribbean, Eastern and Central Europe, the former Soviet Union, and Asia.

Particular concern was expressed about the growing burdens of multilateral debt, with many experts believing that multilateral lending by the major international financial institutions, instead of being a solution, has become an integral part of the debt problem in a number of low-income countries. The manageability of multilateral debt now poses severe challenges for the institutions themselves and for the shareholding governments that they represent.

With regard to the regulation of the financial system and of its two major segments, i.e. the banking and securities markets, concern was expressed that regulatory regimes must be improved so that they can better address the various problems which stem from the global integration of financial markets. However, it was also felt that international private capital flows should not be discouraged by over-regulation.

This volume starts with the address that Jan Pronk, the Dutch Minister for Development Cooperation, held at the beginning of the conference. Subsequently, four themes are discussed: reform of the international monetary system, the globalisation of financial markets, the debt problem, and international macroeconomic coordination. Each theme is explored by experienced international authorities – Peter B. Kenen, Stephany Griffith-Jones, John Williamson, and Richard N. Cooper – and followed by comments from invited panelists and summaries of the floor discussions. The book ends with the closing address by the Dutch Minister of Finance, Wim Kok.

We are grateful for the enthusiast contributions of the participants to the conference. Special thanks go to André Szász and Emile van Lennep who chaired the meetings; Stephany Griffith-Jones and Percy Mistry who were of tremendous help in preparing the conference; and Adriana Bulnes, Peter Mason and Charlie Murphy who assisted in the publishing of this book. The Forum on Debt and Development gratefully acknowledges the support of the Dutch Ministry of Foreign Affairs, the Danish Ministry of Foreign Affairs, and the Swedish International Development Authority.

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Systems in Disarray

Opening Address by Jan P. Pronk, Minister for Development Cooperation of the Netherlands

Introduction

It gives me great pleasure to welcome all of you here on the occasion of the FONDAD conference on the "Functioning of the International Monetary System and the Financing of Development". The issues to be discussed during this conference were identified at an earlier FONDAD conference held in the Hague in 1992. FONDAD is playing an interesting and useful role in bringing together, if I may say so, preachers and practitioners in the field of international financial and monetary relations. With such an august audience, there is always the risk of carrying coal to Newcastle, or, in a more classical reference, bringing owls to Athens. I therefore prefer to take it as my role to put the discussions of today and tomorrow in a wider perspective, both historically and thematically. I will look back at the global economic debate in the seventies, consider a number of subsequent changes, and finish by reflecting upon some of the issues of the nineties.

Looking back to the seventies

My point of departure is the agenda of the 1970s, the agenda of the New International Economic Order, the NIEO. The fundamental objective of the NIEO was to bring about changes in the structure and management of the world economy to enable lasting development. It was a reaction to the failure of the prevailing system which could not solve issues like inequality, inefficiency and overexploitation. It did not aim at a supranational approach to counter the dictate of a few powerful countries and companies, but implied a search for a new world order, a new system of decision-making on an equal footing, on the basis of new principles, different from the ones agreed in the 1940s when GATT and the Bretton Woods system were constituted by a number of countries which could not be considered to represent the whole of the world's population.

The Bretton Woods system was originally conceived to promote trade and employment, rather than to simply guarantee monetary stability; this pledge is part of Article 1 of the IMF's Articles of Agreement. But many in the seventies felt, and some still feel so today, that the IMF had distorted its own mandate and in doing so had distorted real needs. The world of the late 1940s

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into which the Bretton Woods system was born bore little relation to the new realities, and arguments for a new Bretton Woods were put forward. Such a new international system should:

1. fairly represent interests of all countries;
2. prevent collective deflationary domestic policies in the major industrialised countries;
3. recognise some government intervention, on the basis of mutually agreed criteria and procedures, both in international finance and in trade in goods and services;
4. increase international liquidity and relate global credit arrangements to global development capacity rather than to short-term balance of payments adjustments;
5. foster more stable exchange rates, rather than impose self-cancelling devaluation on many economies;
6. promote more stable and lower international interest rates through joint governmental intervention in financial markets; and
7. base global liquidity on a central international reserve currency, the value of which cannot be decisively influenced by the economic policy of one country alone, for example, the United States.

This last idea, the creation of an international reserve asset, I associate directly with Robert Triffin, the well known Belgian-American economist who died in Ostend, Belgium earlier this year. He correctly diagnosed the critical weakness of the Bretton Woods system and recommended the adoption of a system based on an international reserve asset. Incidentally, major intellectual battles have been fought about the specific modalities of allocating this asset, the SDR: the famous "link" debate.

Increasing concessional finance for developing countries was another major objective of the NIEO. After the developments in the early eighties, international finance became an even more urgent issue with the emergence of the debt crisis. From the NIEO point of view a global response to the international debt crisis was proposed. This response should be multilateral, long-term, concessional and integrated with a restructuring of trade relations. Concrete measures proposed at the time included: reducing and capitalising interest rates, putting ceilings on interest payments, extending maturities and grace periods to 15 and 5 years respectively, granting temporary moratoria on debt servicing, establishing an international debt reduction facility, cancelling debt of the poorest countries, and increasing concessional finance and SDRs.

What has changed?

A great number of developments have taken place since those days. Some were gradual developments, with ups and downs, but nevertheless moving in

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a certain direction. Others happened suddenly. Let me sketch you the ones I consider most important. During the last decades the economies of the world integrated with each other to an ever greater extent, not only through trade, which, with very few exceptions, grew faster than output, but also through foreign investment, growing even faster. This integration was greatly helped by technological developments, nowadays allowing not only instant communication all over the world, but also instant capital movement. Some of those developments also had drawbacks. Free capital movement also meant uncontrollable capital movement, as we have found out to our dismay. These developments did not take place evenly throughout the world. Some countries profited more than others. Only a small part of foreign direct investment flows in the 1980s was directed towards developing countries, with roughly three-quarters of the latter amount going to some ten countries.

Another long-term development concerns the industrialisation that took place in developing countries. At the same time, great differences among developing countries have become visible. While long ago developing countries might have been aptly, if not completely truthfully, described as commodity-dependent countries, today the picture is radically different. For low and middle income economies the share of manufactures in total exports doubled from 25-30 per cent in 1965 to 50-55 per cent in 1990, only for Sub-Saharan Africa this share remained stagnant at 7 per cent.

Change and differentiation accelerated in the 1980s under the pressure of circumstances like debts, low commodity prices, severe imbalances, adjustment or lack of it, but also because of the example set by a number of newly industrialising economies. The old paradigm of import substitution shifted towards a new paradigm of world market orientation.

At the same time that developing countries are turning outward, the rich countries hesitate. Vested interests and lack of dynamism lead to a less open attitude vis-à-vis foreign competitors. Non-tariff protectionism practised by the rich countries has been increasing more or less continuously throughout the 1980s despite the Uruguay Round. The very fact that this Round has not yet been completed is not only caused by the complexity of the issues involved, but owes much to this mind set. As a reaction to increasing integration of economies and concomitant competition pressures, global free trade is under threat and regionalism is on the increase.

In the field of international monetary and financial relations we have seen the debt problem come and, to a certain extent, go. We have seen upheavals in foreign exchange markets. International economic coordination is not all that it should be. And it seems we still do not know how to deal with one of the factors involved, viz. the uncontrolled movement of capital.

On a different front, we have recently seen major events in Central and Eastern Europe. While here, too, the process has been a long one in the sense

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of pressures building up, the actual developments, and especially their speed, took all of us by surprise. From one day to the next, a role model for development disappeared. There is no longer a contest between the communist and the capitalist development models. We are all looking now for the optimal mix between market and state, as a pragmatic question. From an economic point of view, the transformation in the former communist countries can also be seen as a more extreme, and possibly more unstable, version of the structural transformation taking place in developing countries.

From a political point of view, these changes are even more impressive. The contradictions that have dominated world politics, and economics, for decades have disappeared. The consequences of this are manifold. Old conflicts in and between developing countries, related to, blown up but also controlled by the East-West confrontation, faded away. New conflicts, often already smouldering for a long time, have erupted, unimpeded now by greater interests, intent upon putting limits to the damage.

In fact, new conflicts have turned out to be much more prevalent than could be foreseen at the time when the Iron Curtain was lifted. We see these conflicts, in different forms, at various places in the world, on all continents. There is a cruel paradox involved here. The greatest threat to mankind in the last decades – nuclear annihilation – has receded and the major powers involved are no longer antagonists. The potential for worldwide cooperation has never been so great. But somehow we are very hesitant to act. We are not sure of our objectives. Our words are not matched by our actions. Or, as The Economist put it recently in relation to the UN system: heart of gold, limbs of clay.

Altogether, the New International Economic Order, as pursued in the past, indeed seems a thing of the past. For political reasons, the rich countries were always very reluctant to pursue it at the time, among other things because it would diminish their control of international institutions. And, from an economic point of view, although the objectives of the New International Economic Order may remain valid, its instruments are mostly outmoded now. Traditional commodity agreements are no longer considered viable. Delinking from the world economy is no longer pursued by developing countries. Transnational companies making use of new technologies in information and communication as well as in production itself can quickly adapt their behaviour to any uncoordinated public decision or regulation in the field of trade and finance. Preferential treatment for exports from developing countries is less relevant nowadays for various reasons: industrialisation in developing countries has become a fact of life and does not require preferences but competition and equal access. Developing countries' economies are much more diversified today, import tariffs in rich countries have decreased and have often been replaced by other forms of

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protection, and, most important of all, many developing countries have become competitive. In a perverse way, the pervasiveness of non-tariff barriers bears testimony to that.

Looking ahead in the nineties

Considering the changes that have taken place, a pervasive feature of the nineties is lack of order and, therefore, lack of stability in international relations. Regionalism is a deviation of the postwar economic order, characterised by non-discriminatory multilateralism. In the financial sphere, uncontrolled capital flows easily destabilise economies, whereas the Bretton Woods system originally regulated these flows in order to assist orderly exchange arrangements. In the political sphere, domestic instability in many countries destroys the perspective for development, and there is no international order to take care of this in a systematic way.

I will now consider some issues in international economic relations in the nineties and their relation to the need for more stability and orderliness in the framework governing those relations. The objective of stability is not to stifle dynamic developments, but to provide a transparent and predictable international enabling environment for relations between countries, without major inequities and inefficiencies. The pursuit of this sort of stability is probably comparable to the pursuit of the Holy Grail in the sense that it is not fully attainable, but it is nevertheless worth trying. The difference is that in the case of pursuing stability, one need not completely achieve the goal to reap some of the advantages. My point of departure will be the interests of developing countries, but with the perspective of mutual advantage for all parties involved.

Trade

In trade relations, I start from the notion of ever more integrating economies. I think it is imperative that developing countries take part in this process as much as they can. As I said, preferential treatment of exports is no longer a useful instrument for many developing countries. The best "preferential" treatment would be for rich countries to abstain from the application of all sorts of grey-area protectionist measures, which mostly do not comply with the spirit if not the letter of GATT rules. Moreover, this protectionism is completely inconsistent with other policies vis-à-vis developing countries. Recent calculations from the World Bank tell us for example that trade barriers applied against Bangladesh cost that country roughly one billion dollars in lost exports. That is equal to almost half of the official development assistance provided to Bangladesh. Corresponding figures – lost exports as a

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consequence of trade barriers in OECD countries – for Jamaica are half a billion dollars (equivalent to almost 3 times ODA for that country) and for Pakistan 1.5 billion dollars (equivalent to 1.25 ODA for Pakistan).

Traditional preferential treatment was meant to promote export competitiveness and industrialisation in developing countries. Nowadays the emphasis is on sustainability of development. To the extent that preferences still make a difference, it would probably be more appropriate to tie preferential treatment to eco-friendly forms of production in developing countries. That way it could serve a different but more useful purpose. It would serve as an incentive for developing countries not to follow the same environment-intensive development path that the rich countries have followed in the past.

Commodity agreements are a traditional instrument in the field of trade. And as in the case of preferential treatment, their usefulness in the traditional sense seems to have passed. On the other hand, one might think about new applications for commodity agreements. Some forms of commodity production are detrimental to the environment. For reasons of competitiveness, countries are often reluctant or unable to take appropriate care of this aspect. It would therefore be useful to link commodity agreements to sustainable production of commodities. These agreements, if coupled with exclusive access to importers' markets for participating exporting countries, would serve as an incentive for sustainable production methods by deterring free riding.

Of course, changing the focus of commodity agreements is not to deny that dependence on commodities still poses a problem for a number of developing countries, especially in Africa. Unstable and mostly structurally low prices are a hallmark of commodity markets in the nineties. Compensatory financing is the immediate remedy, but diversification remains the obvious long-term answer. A stronger link between these two would be welcome.

Finance

Let me now turn to recent developments in the financial and monetary sphere, and more specifically: the SDR issue, the international debt issue, and the issue of the financing requirements of development.

Regarding the Special Drawing Rights, it looks as if this has become more of a political issue than an economic one. SDRs were introduced in the seventies, not as a sole reserve unit as suggested by Triffin, but rather as an additional form of liquidity. The last SDR allocations took place more than ten years ago. They have never been linked to developing country needs. In the past, critics of this idea said that this link would impair the development of the use of the SDR, and would result in over-allocation of SDRs beyond

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the true liquidity needs of the system. A new aspect in the SDR debate is the emergence of new countries which strengthens the argument for a considerable liquidity increase and SDR-allocation. Only recently, Mr. Camdessus, managing director of the IMF, pointed out the low reserve position of especially the small low income countries and the former Soviet Union countries and advocated a new allocation of SDRs. Lack of reserves in these countries can only be compensated by lowering imports. This lack of reserves leads therefore to an artificial and unwanted brake on international trade. An increase in the reserves may enable the world to make a better use of the available production capacity, which is presently underutilised, without risking the danger of fuelling global inflation. The world requires growth and trade and therefore more liquidity. The creation of SDRs, well planned, on the basis of a study of the need, in adequate annual instalments and fairly distributed, could be a very useful instrument in a policy to better integrate trade and finance.

The problem of international debt has changed considerably in nature. The actual debt crisis of the eighties, from a global point of view dominated by the Latin American share with its predominantly commercial nature, has been neutralised, without endangering the international banking community and the stability of the international monetary system. In the Paris Club, ways have been found to start dealing with official government-to-government debt of the poorest countries. Since the last time I addressed a conference organised by FONDAD in 1990, we have seen some developments in this field, including the proposal by myself and my colleague Wim Kok in September 1990 to completely cancel the debt of the poorest countries. This was not acceptable to other creditors, but it may have helped to catalyse the decisionmaking process in the Paris Club. The adoption of Enhanced Toronto Terms (50% write off) by most creditor countries is a step in the right direction. Recently Lawrence Summers, who left the World Bank to serve in President Clinton's administration at the US Treasury, announced that his department has proposed to the U.S. Congress to participate in debt relief along the lines of Enhanced Toronto Terms for many countries. I consider the increasing consensus on these terms as a positive development.

However, the problem of debt in Africa is far from over. Commercial debt may not be such a large part of total debt. IDA debt reduction operations may have helped in a number of African countries to eliminate parts of this commercial debt. Bilateral official debt may be dealt with in the Paris Club on increasingly concessional terms. However, debts owed to the multilateral international financial institutions seem to be increasing in weight and size. Relatively little research is done on the issue of multilateral arrears and debt service. The multilateral financial institutions have not been forceful and creative development agents in this respect. Of course, it would be too easy to

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say that they should simply reduce the debt owed to them. Their position is very different from all other creditors. However, continuing the present attitude of benign neglect is no way out of the debt trap.

The financing requirements of developing countries have been calculated under different assumptions by several researchers and institutions. These calculations, although they have severe limitations, do offer some indication regarding orders of magnitude. I would like to mention some model-based findings in this field by Mr. Robert Lensink, of Groningen University. For Sub-Saharan Africa he finds, in a base line scenario, that funding to the amount of US$ 30 billion is needed to maintain present per capita GDP growth rates. Given only minor private flows and projected official flows of some US$ 11 billion there remains a financing gap of US$ 18 billion!! Another finding in this scenario is that Sub-Saharan Africa would not regain creditworthiness until at least the year 2000. Given these figures, a thorough examination of means available to increase official flows to these countries seems called for.

In the seventies the G-24 countries, in their debates with the Bretton Woods institutions and the G-10 countries, did manage to increase available IMF resources likely to favour developing countries: the Extended Fund Facility, the Special Oil Facility, the enlarged access policy in general and the establishment of the Trust Fund are examples of this. Additional mechanisms have been developed since, like the (Enhanced) Structural Adjustment Facility and, most recently, the Systemic Transformation Facility. I did refer already to the issue of SDRs above and here I would only like to add that the Compensatory and Contingency Financing Facility for developing countries in my opinion has not been fully exploited.

Let me reiterate here what I said three weeks ago at a Seminar on Structural Adjustment held here in The Hague: as a politician I am inclined to foresee that, in future, bilateral donors will be less and less inclined to provide external resources in order to finance development in developing countries. This should serve as an additional incentive to the Bretton Woods institutions to attempt to meet the financing needs of those countries in particular who are not likely to regain creditworthiness in the near future. Regarding financing, let me add that I am not looking for grand initiatives. Rather, as a famous American senator (Everett Dirksen) used to say: a billion here, a billion there, and pretty soon we're talkin' real money.

Transition

A new item on the agenda of the nineties is of course the economies in transition of the former communist countries in Eastern Europe and the former Soviet Union. An important aspect of this painful transformation is

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the speed of the adjustment process: big bang versus planned, orderly transition. There are economic, political and social aspects involved in this process. Even in Poland, with many elements of the big bang approach, the process is under great political pressure. Are there lessons to be learned from transition experiences in developing countries that are useful for the former communist countries? I believe so. The UNCTAD study on International Monetary and Financial Issues for the nineties looks at the so-called Southern Cone experiments in liberalisation in the late seventies and the early eighties and arrives at the following four conclusions:

- the transitional period is long and difficult to manage, and the state has a crucial role in sequencing trade liberalisation, decontrolling capital accounts and liberalising the financial system;
- the transition is a painful one with social costs associated and this requires the government to take political constraints into consideration;
- during transition there will be a reduced availability of credit;
- the state has a crucial role in regulating the economy: especially the financial system must be tightly supervised.

At the Annual Conference on Development Economics of the World Bank, 1993, it was pointed out that the successful gradual economic liberalisation undertaken by China since the late seventies started out by liberalising agriculture first, followed some years later by light industry, together providing for fast development of rural areas. Also, international trade was only gradually liberalised through special economic zones. This may provide valuable lessons for those Eastern European countries that opted instead for the Big Bang approach. Of course, there are also differences to be taken into account, such as the state and the structure of the economy.

Let me end with a word on globalisation, i.e. the increasingly transnational character of economic and financial processes. Some of these processes are getting more and more outside the scope of national authorities, while they may have a great impact on the position and functioning of national economies. The most important actor involved in globalisation is the transnational company. Globalisation implies increasing competition. Competition among transnational firms is at the same time competition among regulatory systems of nations. Both types of competition imply great risks of increasing friction between countries or groups of countries. We must contain those frictions before they start to overwhelm us. In other words, the Uruguay Round should finally be brought to an end, to allow us to tackle the important issues of the nineties: trade and competition, trade and investment, trade and the environment. And on exchange rates and capital flows, we must come to grips with the impossible triangle of unstable exchange rates, lack of coordination of economic policies and free capital flows. Policy coordination and a strong surveillance role for the IMF seem to

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me crucial to improve the functioning of the international monetary system and to prevent monetary adjustments taking place with the severity we witnessed in the EMS only recently.

Policy coordination and a strong surveillance role of the IMF: What does it mean? It means a return to a situation whereby there would be no longer a distinction between macroeconomic coordination, on the one hand, and exchange rate coordination, on the other. It means that the IMF would again be seen as the beginning of a world central bank, with powers vis-à-vis transnational commercial banks as well as vis-à-vis countries in deficit – not only the small ones – and countries in surplus. It means an IMF which would control a sizeable percentage of world liquidity, not only a slight percentage of world's imports but – say – something closer to the White proposal in the early fourties (and we know that this was much less than the proposal by Keynes). It means an IMF which would help reinstall global monetary discipline as against speculative private capital destabilising economies. It means a system which would not only concentrate on poor countries with only a small position of the world liquidity but on all actors, in order to contribute to the most important target of any market economy: full employment. It means building systems and procedures which fit into a global civil society.

In such a global civil society we need equity but also order and stability. Of course it is very difficult, when you are in the middle of tumultuous changes, to be aware of the direction and magnitude of the forces involved. It is only too easy to cling to old values and perceptions. However, we should try to be creative, because the times have changed. The nineties are a decade of transformation, not only for individual countries, but also for the international order, be it economic or political, within which they operate. If we just stick to the answers of the eighties we are bound to fail.

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Reforming the International Monetary System: an Agenda for the Developing Countries

Peter B. Kenen

Introduction

When economists have gathered to consider the connection between reform of the international monetary system and the concerns and aspirations of the developing countries, they have typically begun by asking how the monetary system should be reformed and have then gone on to ask how the reform might be designed to serve the interests of the developing countries. The long debate about international liquidity supplies the clearest illustration. We began by trying to devise a persuasive case for adding to the stock of reserve assets by issuing Special Drawing Rights (SDRs), then sought ways to distribute them that would transfer real resources to the developing countries – the so-called "link" in its various versions.

That strategy was unsuccessful. Some have even said that it was self-defeating, because it raised questions about the integrity of the basic case for monetary reform.[1] Were the advocates of SDR creation moved mainly by concerns about a global reserve shortage, or were they chiefly interested in transferring resources to developing countries? It is impossible to answer that question decisively, and there is no point in trying. It is important to concede that we can no longer tie the two issues together, because there is almost no interest today in any large-scale reform of the monetary system.

In Western Europe, the energies of those concerned with monetary matters are focused on rebuilding and safeguarding the exchange-rate mechanism of the European Monetary System (EMS) and, over the longer run, implementing the plan for monetary union in the Maastricht Treaty. In the United States, the Clinton administration wants to revive macroeconomic cooperation among the G-7 countries. It is worried, with good reason, about the short-run effects of simultaneous fiscal contractions in no fewer than five of the G-7 countries (Britain, France, Germany, Italy, and the United States), which plan to raise taxes in 1994 or 1995. It has been pushing Japan in the

1 John Williamson, "International Monetary Reform and the Prospects for Economic Development," in J.J. Teunissen, ed., "Fragile Finance: Rethinking the International Monetary System", Forum on Debt and Development, The Hague, 1992.

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opposite direction and, with rather less success, has been urging the Bundesbank to cut German interest rates. But the new administration has shown no interest in returning to intensive exchange-rate management of the sort that followed the Louvre Accord in 1987. At the Little Rock economic summit, the President-elect said that he favoured a strong dollar. Weeks later, however, Lloyd Bentsen, the new Secretary of the Treasury, was widely praised in Washington for talking up the yen and thus talking down the dollar. Not surprisingly, Japanese businessmen, economists, and officials have begun to express dissatisfaction with the existing monetary system, but no one else seems to be listening.

There is thus little point today in pursuing the old strategy – calling for reform of the monetary system and then asking how the developing countries can turn reform to their advantage. We have instead to ask what changes in the monetary system might most directly meet the needs of the developing countries themselves. To be realistic, moreover, we must confine our attention to those changes in the system that do not impose unacceptable costs on the industrial countries and do not crowd out other forms of development assistance.

This last constraint is daunting. Let us make no mistake about it. The governments of the industrial countries are deeply preoccupied with their own economic and social problems. Democracies are stingy when resources are seen to be scarce, because elected political leaders must look first to the needs and aspirations of their own citizens, even when their citizens are far better off than those of other countries. They cannot be expected to worry about prenatal care and nutritional needs in Brazil or Nigeria when they are trying to find ways of financing adequate medical care for their own citizens. They cannot be expected to worry about ethnic violence in India or Sri Lanka when they must deal with poverty and violence in their own cities. And when they have managed to convince themselves that they have no moral obligation to intervene militarily when thousands must flee for their lives in Bosnia, they find it far too easy to convince themselves that they have no moral obligation to intervene economically when millions of people live at the edge of subsistence all over the world. There are limits to altruism and even tighter limits to tax-financed altruism.

The outlook may be brighter two or three years hence, when the industrial countries have worked their way out of the current recession, but I would not count on that. Fundamental changes in technology and trade may have diminished the ability of the advanced industrial economies to create new jobs or, more precisely, their ability to absorb large numbers of semi-skilled and low-skilled workers. Those countries may face more inequality at home, which will further reduce their political capacity to combat inequality in the outside world.

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These same basic changes in the demand for labour, especially those that are seen to reflect the migration of manufacturing to developing countries, raise another issue that must be mentioned briefly. If the developing countries were forced to choose between ways to make the monetary system more responsive to their needs and ways to strengthen the multilateral trading system, they would be well advised to opt for strengthening the trading system and, in particular, for the speedy and decisive adjudication of trade-policy disputes. They must work to halt the tendency of the industrial countries – including my own – to define arbitrarily and enforce unilaterally rules against dumping and other "unfair" practices. An efficient GATT system for settling trade disputes will come down hard on certain developing countries, because of their trade practices. But the developing countries will be far worse off if the dispute-settlement process is not reformed, as they will be the principal victims of new trade restrictions imposed in the name of the environment or fair labour standards but designed to exclude their exports from the developed countries' markets. Ironically, some of the same people who most strongly support measures to alleviate poverty in the developing countries may prove to be those countries' most dangerous enemies, because they favour the use of trade measures to advance environmental causes.

Returning to my main theme, the monetary system, let me offer one more warning. The last two years have shown that the G-7 countries are willing to innovate and improvise when it suits their purposes – to tap the resources and modify the policies of the International Monetary Fund (IMF) in order to mobilise aid for Russia. I am indeed concerned that they have done so in ways that will injure the Fund financially and impair its ability to deal appropriately with its other members' problems. Their willingness to take those steps in this particular case, however, speaks to the severity of the financial and political constraints that prevent them from using their own resources for foreign-policy purposes. It would be naive for developing countries to treat the Russian case as a compelling precedent for making broader changes in the rules of the Fund, although I shall argue shortly that such changes should be made.

I. THE CHANGING ECONOMIC ENVIRONMENT

Before examining ways in which the international monetary system can be adapted or reformed to make it friendlier to the needs of developing countries, let us pause to consider two major changes in the policies and circumstances of those countries themselves. The first is the change in their own exchange-rate arrangements. The second is the change in the nature and

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degree of their access to international capital markets. Both bear on their need for reserves and on the cost of acquiring them.[2]

The migration to exchange rate flexibility

A country's need for international reserves depends on the way in which its nominal exchange rate is determined. If its exchange rate floats freely, without official intervention, the country does not need reserves (unless it wants to retain the option of intervening in the future). If its exchange rate is pegged to another country's currency or to a basket of currencies, it must have enough reserves to bridge temporary gaps between demand and supply in the foreign-exchange market, regardless of the underlying reasons for the gaps. When some market participants want to sell more of a country's currency than other market participants want to buy at the existing exchange rate, the central bank must draw down its stock of reserves to buy up the excess supply of its currency; otherwise, the currency is bound to depreciate.

Much importance attaches to the word "temporary" in the previous paragraph. No finite stock of reserves can bridge a permanent gap between supply and demand in the foreign-exchange market. Even in such cases, however, reserves can be used to buy time for a government to make the policy changes needed to eliminate a permanent gap – tightening its monetary and fiscal policies in order to reduce aggregate demand and thus the demand for imports or raising its nominal interest rate relative to rates in the outside world in order to attract capital inflows and discourage capital outflows.

In general, then, the size of the stock of reserves required to keep an exchange rate pegged depends on the size and duration of the temporary shifts of demand and supply in the foreign-exchange market and the speed with which a government can make the policy changes needed to reverse or offset a permanent shift in demand or supply reflecting a fundamental change in the foreign demand for its exports and assets or its own demand for imports and for foreign assets. But three additional considerations bear on the adequacy of a country's reserves:

1. The larger the stock of reserves, the less likely a "run" on a country's currency resulting from expectations that it will be forced to devalue its currency.
2. Dependable access to credit facilities, like those of the Fund, reduces the need to hold reserves, although reserves and reserve credit are not perfect substitutes.

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2 The next sections draw on a previous paper: Peter B. Kenen, "Financial Opening and the Exchange-Rate Regime," in H. Reisen and B. Fischer, eds., "Financial Opening: Policy Issues and Experiences in Developing Countries", OECD Development Centre, Paris, 1993.

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3. As a country can always run down its reserves to build up its capital stock, there is an opportunity cost to holding reserves; it can be represented by the rate of return on the resulting addition to the capital stock less the rate of return on reserve assets.

There is no need to dwell at length on these familiar propositions, but brief comments are in order.

Although large reserves may help to ward off speculative pressures, no country can hope to defend a pegged exchange rate unless it pursues domestic policies that impart credibility to the exchange rate. The recent literature on exchange-rate policy has argued that a firm commitment to a pegged exchange rate can impart credibility to domestic policies, and this argument has influenced exchange-rate policy in several developing countries. But a two-way process is involved here. By committing itself to a pegged exchange rate, a government can perhaps persuade firms, workers, and foreign investors that it is ready to gear its monetary policy to the pursuit of price stability, without which it cannot defend a pegged rate. If so, it can affect their behaviour in ways that will help it achieve price stability. In the long run, however, the success of a commitment to a pegged exchange rate will depend on the domestic policies actually pursued. Credibility can be borrowed by pegging the exchange rate, but it must be repaid from the credibility earned by domestic policies. Large reserves can help, but they cannot insulate a pegged exchange rate from speculative pressures induced by a deterioration of the so-called fundamentals.

Recent European experience illustrates my point. On the eve of the 1992 EMS crisis, Britain had larger foreign-exchange reserves than Italy, and Italy had larger reserves than France. Going back to the start of the EMS, moreover, you will find that the French franc was devalued in terms of the Deutsche mark almost as often as was the Italian lira (six times for the franc, compared to eight for the lira, including occasions on which the mark was revalued in terms of all other EMS currencies). Yet the franc survived the September crisis, and the lira and pound did not, partly because French policies had earned more credibility than British or Italian policies.

The 1992 EMS crisis teaches us another lesson. Under the rules of the EMS, member countries are entitled to expect that they will be able to draw unlimited amounts of reserve credit from other EMS countries, and these facilities were used extensively during the 1992 crisis. But the availability of these credit facilities did not deter speculation, partly because market participants know that short-term credit has to be repaid. When a country draws down its own reserves to defend a pegged exchange rate, it can decide for itself when and to what extent it should rebuild them. When it uses reserve credit, by contrast, it must repay what it borrows and on terms

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acceptable to its creditors. It has less flexibility.[3] That is why I said before that owned reserves and reserve credit are not perfect substitutes.

The third point made earlier deserves particular emphasis, as it calls into question a common belief about the cost of acquiring reserves. Countries that have access to international capital markets, it is said, can acquire reserves by borrowing. Countries that lack access to those markets must sacrifice real resources. As John Williamson put it, "poor countries have to provide reverse aid to the rich in order to build up a prudent level of international liquidity."[4] This statement is half right – but that makes it half wrong.

A country that has access to international capital markets can, of course, borrow to build up reserves, augment its capital stock, or even spend more on current consumption. It must therefore decide how much to borrow and how to use the proceeds by comparing the cost of servicing additional debt with the benefits conferred by each potential use of the proceeds of new borrowing, and one would expect it to use some of the proceeds for reserve accumulation. A country that does not have access to international capital markets cannot engage in this sort of optimisation. Yet the two countries' cases are not so very different. Both of them must sacrifice current or future consumption to build up their reserves. They differ only in respect of the margin at which they must make their choices. The country that can tap international capital markets enjoys an extra degree of freedom. It can use borrowed resources, as well as its own resources, for reserve accumulation or capital formation.

Has this distinction any practical significance? It can perhaps explain why the developed countries have rejected the view expressed by Williamson and many others that the international monetary system is unfair to the poorer countries and that the inequity should be corrected by creating SDRs.

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3 The need to return to the status quo ante, by rebuilding reserves in the one case and repaying reserve credit in the other, should in principle affect the choice between financing and adjustment, even in the case of a temporary shock. If a government finances a current-account deficit by using reserves or reserve credit, it must plan to run a current-account surplus at a later date. Hence, it may not be optimal for a government to finance a deficit fully but rather to reduce the deficit partially by altering its macroeconomic policies. The optimal choice between financing and adjustment will depend on the extent to which a government discounts the future cost of rebuilding reserves and repaying reserve credit and on the expected distribution of future balance-of-payments shocks. If "good" and "bad" shocks are distributed symmetrically, a government may not have to plan on taking costly measures to generate a current-account surplus in the future; it can plan to take advantage of good outcomes in the future to rebuild the reserves or repay the reserve credit it is using to finance a bad outcome now. This possibility reinforces the case for holding and using reserves rather than relying on reserve credit, as a government cannot know in advance when it will experience a good outcome. See Peter B. Kenen, "Financing, Adjustment, and the International Monetary Fund", The Brookings Institution, Washington, 1986.

4 Williamson, "International Monetary Reform," p. 91.

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Suppose that the developed countries increased their own untied aid to the poorer countries. A rational recipient would presumably allocate some of the extra aid to reserve accumulation, some to capital formation, and some perhaps to current consumption (if it were free to do so). And that is how we should expect it to behave if it received more aid *via* an SDR allocation. We should not expect it to build up its reserves by the full amount of the allocation but rather to use some of the new SDRs for capital formation or extra consumption. In other words, we should expect the poorer countries to use some of the new SDRs to acquire real resources from the developed countries.

Let me add at once that, though we should expect this outcome, we should not object to it. Five years ago, I might have agreed with those who believed that any additional transfer of resources to the developing countries should be matched by a tax-financed increase of untied aid, not by creating and spending additional SDRs. In other words, SDR creation might have intensified inflationary pressures, not by raising world reserves – the silliest of monetarist fallacies – but by adding to aggregate demand in the developed countries. Right now, however, there is deficient demand in the developed countries, taken as a group, and no conceivable reason to worry about the small increase in aggregate demand that they would experience if the developing countries chose to spend some of their SDRs rather than add them to their reserves. In brief, an SDR allocation would be the only available substitute for more untied aid, and I can think of many ways in which the developed countries might then use *their* SDRs to help the developing countries – to grant interest subsidies or debt relief to the low-income countries or even to finance the next IDA replenishment. But the case for a new allocation should be made frankly and pragmatically. An SDR allocation would not greatly improve the functioning of the international monetary system or make the system fairer. It would be a way to offset an apparent imperfection in international capital markets or, more generally, a way to redistribute real resources from rich to poor countries.

Thus far, I have focused implicitly on the role of reserves under pegged exchange rates. In the 1980s, however, many developing countries migrated from pegged to flexible exchange rates, and some of them moved all the way to floating rates. The extent of the migration is described by Table 1, which is based on the classification of exchange-rate arrangements maintained by the IMF. The numbers in the table must be used with caution, because they depend on the way in which individual governments report their exchange-rate arrangements to the Fund, and some governments have failed to keep the Fund fully informed. Although Poland pegged its exchange rate at the beginning of 1990, with the support of the Fund itself, you will find no trace of the decision in the Fund's listing of exchange-rate arrangements. And

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some other well-known but short-lived innovations in exchange-rate policy are not recorded in Table 1; they were not reported by the governments concerned. Nevertheless, my own statistical analysis of the Fund's numbers suggests that, by and large, they capture the broad trends in exchange-rate policies and in actual exchange-rate behaviour.[5]

Table 1 describes the exchange-rate arrangements adopted by 37 "small" developing countries and 81 "large" developing countries. The countries are those that appear continuously in the Fund's tabulations from 1982 through 1991, and the small ones are those with populations no larger than 2 million.

Table 1 Classification of Developing Contries' Exchange-Rate Arrangements (ends of calendar years)

	Small Countries		Large Countries	
Arrangement	1982	1991	1982	1991
Pegged to single currency	19	18	34	21
Pegged to SDR	5	1	9	5
Pegged to other composite	7	9	11	14
Flexibility limited in terms of single currency	5	3	5	1
Adjusted according to set of indicators	0	0	4	4
Other managed floating	1	4	14	17
Independently floating	0	2	4	19
Total	37	37	81	81

Source: Peter B. Kenen, "Financial Opening and the Exchange-Rate Regime," in H. Reisen and B. Fischer, eds., *Financial Opening: Policy Issues and Experiences in Developing Countries.* OECD Development Centre, Paris, 1993.

Look first at the small countries. In 1982, when the Fund introduced the categories used in Table 1, most of the small countries had pegged rates; 19 were pegging to a single foreign currency, and 12 more were pegging to baskets of currencies, including the SDR.[6] A decade later, in 1991, the

5 Peter B. Kenen, "Floating Exchange Rates Reconsidered," in P.B. Kenen, F. Papadia, and F. Saccomanni, eds., "The International Monetary System: Essays in Memory of Rinaldo Ossola", Cambridge University Press, Cambridge & New York, forthcoming.

6 As a practical matter, moreover, the five countries with flexibility limited in terms of a single currency may be regarded as having pegged rates; their nominal exchange rates have not been much more volatile in the short run than those of the countries with strictly pegged exchange rates.

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situation had not changed very much; 28 small countries had pegged rates, compared to a total of 31 in 1982. This finding reminds us of McKinnon's contribution to the theory of optimum currency areas.[7]

But look next at the large countries. In 1982, 54 of them had pegged exchange rates; 34 were pegging to a single foreign currency, and 20 more were pegging to baskets of currencies. At the opposite extreme, only four countries had independently floating rates. A decade later, however, only 40 of these countries had pegged rates, and 19 had independently floating rates. As recently as 1989-91, 12 of these countries moved from pegged-rate arrangements to more flexible arrangements, with seven moving all the way to independent floating.

Taken by itself, the migration of the developing countries to exchange-rate flexibility would appear to cast doubt on the case for increasing the stock of reserves. There is, of course, no simple, inverse relationship between the extent of exchange-rate flexibility and the need for reserve assets. A country that has pegged its exchange rate firmly for many years is apt to need smaller reserves than one that has changed its pegged rate often or by large amounts. Furthermore, most countries with flexible exchange rates do not let their rates float freely and they thus need reserves. They may, in fact, require larger reserves than countries with firmly fixed exchange rates. Much will depend on each country's exposure to international capital flows – which takes us to the other important development mentioned at the start of this section.

The resumption of capital inflows

Let us look first at the good news. There has been a remarkable revival of foreign investment in several developing countries, mainly in Latin America and Southeast Asia. In 1986-88, the net capital flow to developing countries totaled only $7.7 billion; in 1989-91, it totaled $132.3 billion.[8] The inflow included a huge increase of foreign direct investment, which rose from $49.3 billion in 1986-88 to $120.7 billion in 1989-91.[9] It also included portfolio

7 Ronald I. McKinnon, "Optimum Currency Areas," In: American Economic Review, 63, 1963.

8 International Monetary Fund, "Balance of Payments Statistics Yearbook", 1992, Part II, Tables A-2 and A-4; figures exclude exceptional financing. The corresponding figures for Asia, Africa, and the Western Hemisphere are – $12.0 billion (a net outflow) and $68.0 billion. The gaps between these figures and those in the text reflects large inflows to countries of the Persian Gulf.

9 Ibid., Table C-17; these are total direct-investment inflows, not net of the investments made by the developing countries themselves. The corresponding figures for Africa, Asia, and the Western Hemisphere were $44.2 billion in 1986-88 and $83.6 billion in 1989-91.

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investment and net lending by foreign banks, shown in Table 2. The banks' claims on the Asian countries rose by $79.2 billion in 1989-92, and though the banks' claims on the Western Hemisphere countries fell in that same period, the reduction was smaller than the cut resulting from negotiated debt reductions.

Table 2 Cross-Border Claims of Foreign Banks on Developing Countries (billions of U.S. dollars)

	Interbank					Other				
Region	1988	1989	1990	1991	1992	1988	1989	1990	1991	1992
Africa	13.44	13.67	13.22	13.73	14.33	44.33	42.91	47.08	43.66	40.56
Asia	64.11	64.21	76.49	96.49	107.06	87.64	90.65	101.42	114.95	123.94
Western Hemisphere	137.43	142.72	144.30	150.57	141.47	173.27	160.48	145.04	147.40	155.33

Source: International Monetary Fund, *International Financial Statistics,* May 1993. Interbank and other claims on Africa exclude claims on South Africa; interbank claims on Asia exclude claims on Hong Kong and Singapore; interbank claims on the Western Hemisphere exclude claims on the Bahamas and Cayman Islands, and other claims exclude claims on the Cayman Islands and Netherlands Antilles. (Interbank claims for 1992 exclude mid-year claims on the Bahamas, as end-year data were not available.)

Most of the countries receiving large capital inflows have used some of the proceeds to absorb real resources; they have run current-account deficits or reduced their current-account surpluses. But most of these countries have also built up their reserves. The balance-of-payments accounts for six of the capital-importing countries are summarised in Tables 3A and 3B. In the Mexican case, net capital inflows rose from $1.0 billion in 1989 to $20.4 billion in 1991, apart from exceptional financing; the current-account deficit grew by $9.3 billion; and reserve accumulation grew by $7.6 billion (from $0.5 billion to $8.1 billion). In the Indonesian case, net inflows rose from $2.9 billion in 1989 to $6.1 billion in 1991; the current-account deficit grew from $1.1 billion to $4.1 billion, and reserve accumulation grew by $1.7 billion (from a loss of $0.5 billion in 1989 to a gain of $1.2 billion in 1991).

Many explanations have been given for the revival of capital inflows. They include the measures taken by the capital-importing countries to stabilise and liberalise their economies, assisted in some cases by negotiated debt reduction. But events in the outside world also played a role, most notably the

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fall in interest rates on dollar assets, which prompted foreign banks to lend more (at higher interest rates) to developing countries.[10]

The reasons are important, because they bear on the sustainability of the situation. It would not take an outright withdrawal of foreign capital, merely a cessation of the inflow, to cause painful problems for the capital-importing countries. Recall that the 1982 debt crisis was not triggered by a sudden capital outflow, but by the cessation of additional bank lending. Yet the sustainability of the situation also depends on the way that the capital-importing countries deal with the monetary consequences. They must strike a

Table 3A Balance-of-Payments Accounts for Argentina, Mexico, and Venezuela (billions of U.S. dollars)

	Argentina			Mexico			Venezuela		
Category	1990	1991	1992	1989	1990	1991	1989	1990	1991
Trade balance	8.63	4.58	-1.68	-0.65	-4.43	-11.06	5.63	10.64	4.79
Current-account balance	1.90	-2.80	-8.55	-3.96	-7.12	-13.28	2.16	8.28	1.66
Direct investment	2.01	2.44	4.69	2.65	2.55	4.74	0.08	0.10	1.77
Portfolio investment	-1.61	-0.20	-3.11	0.44	-5.36	6.94	-0.16	13.58	0.11
Other capital:									
Official sector	-0.56	-0.43	-0.62	-0.10	1.80	-0.87	-1.31	-16.50	-0.43
Banking sector	0.10	-0.03	-0.06	-0.14	8.50	6.53	0.33	-0.91	0.17
Other sectors	-2.36	-5.12	9.41	-1.88	0.96	3.04	-4.17	-0.82	1.31
Exceptional financing	3.22	9.09	2.67	0.39	0.08	0.02	1.85	1.43	0.29
Errors and omissions	0.71	-0.34	0.14	2.78	0.89	0.87	1.42	-1.74	-2.42
Use (+) of IMF credit	-0.26	-0.59	-0.07	0.36	0.96	0.16	0.96	1.90	0.22
Increase (-) in reserves	-3.15	-2.02	-4.50	-0.54	-3.26	-8.15	-1.16	-5.32	-2.68

Source: International Monetary Fund, *International Financial Statistics,* May 1993; detail may not add to total because of rounding. For Argentina and Venezuela, changes in liabilities constituting reserves of foreign monetary authorities are netted against changes in reserves.

10 See, e.g., Pedro Pablo Kuczynski, "International Capital Flows to Latin America: What is the Promise," Proceedings of the World Bank Annual Conference on Development Economics, World Bank, Washington 1992; Stephany Griffith-Jones et al., "The Return of Private Capital to Latin America," in J.J. Teunissen, ed., "Fragile Finance: Rethinking the International Monetary System", Forum on Debt and Development, The Hague, 1992; and Charles Collyns, et al., "Private Market Financing for Developing Countries", International Monetary Fund, Washington, 1992.

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Table 3B Balance-of-Payments Accounts for Indonesia, Malaysia, and Thailand (billions of U.S. dollars)

	Indonesia			Malaysia			Thailand		
Category	1989	1990	1991	1989	1990	1991	1989	1990	1991
Trade balance	6.66	5.35	4.80	3.91	1.90	-0.17	-2.92	-6.75	-5.99
Current-account balance	-1.11	-2.99	-4.08	-0.21	-1.63	-4.53	-2.50	-7.28	-7.56
Direct investment	0.68	1.09	1.48	1.67	2.33	4.07	1.73	2.30	1.85
Portfolio investment	-0.17	-0.09	-0.01	-0.11	-0.26	0.17	1.49	-0.04	-0.08
Other capital:									
Official sector	2.78	0.47	1.25	0.03	0.70	0.31	-0.54	-1.22	0.26
Banking sector	—	—	—	0.40	0.58	1.65	0.70	1.03	0.21
Other sectors	-0.37	3.02	3.41	-0.45	-1.10	-0.70	3.23	7.02	9.52
Errors and omissions	-1.31	0.74	-0.52	-0.10	1.33	0.27	0.93	1.42	0.42
Use (+) of IMF credit	—	-0.16	-0.32	—	—	—	-0.36	-0.27	—
Increase (-) in reserves	-0.50	-2.09	-1.21	-1.23	-1.95	-1.24	-4.67	-2.96	-4.62

Source: International Monetary Fund, *International Financial Statistics,* May 1993; detail may not add to total because of rounding.

careful balance between importing real resources and building up reserves and must avoid the monetisation of reserve accumulation.

If a country tilts too far in favour of importing real resources by allowing a large deterioration in its current-account balance, it will make itself very vulnerable to any future interruption of the capital inflow (and to political pressures from sectors adversely affected by the increase of imports that brings in the real resources). If it tilts too far in favour of acquiring reserves, it may end up in the worst of all worlds – with inflation, a larger current-account deficit and, eventually, a loss of reserves.

It is hard for many developing countries to sterilise an increase of reserves; their financial markets are not broad enough for the central bank to sell large amounts of domestic assets, and such sales, when they do occur, add to the government's interest bill and the budget deficit.[11] Therefore, reserve accumulations are frequently monetised and tend thus to generate inflationary pressures. Countries that have trouble managing the monetary

11 In some developing countries, moreover, such as Argentina and Malaysia, the central bank cannot sterilise reserves, because it does not hold domestic assets.

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consequences of reserve accumulation are compelled to choose between two unpleasant options – refraining from reserve accumulation and allowing the nominal exchange rate to appreciate or engaging in nonsterilised intervention and allowing the domestic price level to rise. In both cases, of course, the currency will appreciate in real terms and the current account will deteriorate. The country will import real resources, whether it wants them or not. In the latter case, moreover, it may lose the reserves it wanted to acquire.

Sustainability also depends on the ability of a capital-importing country to make sure that the real resources it chooses to acquire by running a current-account deficit are used for capital formation, not consumption. Otherwise, its output will not grow apace with the income payments it must make to foreigners.

This should not be done by trying to control the character of the capital inflow – by favouring those forms of foreign investment that seem to be most closely linked to capital formation. A government adopting that approach would have to examine intrusively each and every capital-account transaction. It could not merely favour certain broad classes of foreign investment. It would be wrong, for example, to favour foreign direct investment without ascertaining how much of it is meant to finance "greenfield" projects rather than the acquisition of existing assets. It would likewise be wrong to discriminate against foreign portfolio investment without asking what it can contribute to the broadening and deepening of domestic financial markets, making it easier for local firms to issue new securities and thus raise funds for capital formation.

To make the best use of a capital inflow, a capital-importing country must seek to promote investment per se, by residents as well as foreigners. It must follow macroeconomic policies aimed at promoting domestic stability. It must adopt microeconomic policies, especially tax policies, that favour saving and investment rather than consumption.

There are, of course, other valid reasons for capital-importing countries to favour certain sorts of foreign investment – those that do not generate fixed foreign-currency debt-service payments or tie such payments to short-term foreign interest rates. That is why the capital-importing countries can afford to be more comfortable with the medium-term implications of the present situation, involving as it does large inflows of foreign direct investment and, in certain instances, inflows of portfolio investment as well. For this same reason, moreover, one may question the need for an International Debt Restructuring Agency of the sort proposed by Cohen and endorsed by Williamson.[12] It could not possibly "work out" the heterogeneous

12 Benjamin J. Cohen, "Developing Country Debt", Essays in International Finance, 173. International Finance Section, Princeton University, Princeton, 1989, and Williamson, "International Monetary Reform," pp. 94-95.

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obligations of a country whose "foreign creditors" are mainly direct investors and holders of marketable claims on the private sector.

It must be recognised, however, that the revival of capital inflows is a "fair weather" phenomenon, reflecting the new confidence of foreign investors in the medium-term economic outlook for the capital-importing countries. Those countries cannot count on having access to "liability financing" for use when the weather worsens. They must have adequate reserves of their own, as well as reliable access to reserve credit from the Fund. And this is the case not only for the low-income countries, which have no access whatsoever to international capital markets, but also for the middle-income countries, which must be able to finance temporary balance-of-payments deficits caused by adverse capital-account shocks as well as those resulting from current-account shocks.

II. IMPLICATIONS FOR THE MONETARY SYSTEM

There has been a large increase in the reserves of developing countries. It is shown in Table 4, which traces the growth of their reserves from 1981, the last year before the debt crisis, through 1992 (and also shows their obligations to the IMF). It is shown differently in Table 5, which measures reserves in weeks of imports. The figures in the last two columns of Table 5 are particularly striking. Measured in weeks of imports, reserves have risen uniformly since 1981, in every regional group and every income group. The increase in reserves has been especially large for the African countries and, correspondingly, for the low-income countries (many of which are African countries). In consequence, it is impossible to adduce a strong statistical relationship between the levels of countries' reserves in 1991 and their per capita incomes.[13]

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13 See Table A-2 in the appendix to this paper. There is a significant positive relationship between reserves and incomes for the middle-income countries; see equation (3) in Table A-2. But there is no such relationship for the whole group of developing countries covered by my calculations or for the low-income countries taken by themselves; see equations (1) and (2). These results may reflect the effects of the inverse relationship shown for the African countries by equation (4); it is not statistically significant but may be strong enough to dilute the expected positive relationship between reserves and per capita incomes for the whole set of developing countries and the low income-countries. There is a clearer relationship between reserves and per capita incomes for the Asian and Latin American countries; see equation (5). Table A-2 reports two more calculations. Equation (6) links the changes in reserves between 1981 and 1991 to the 1981 levels and to 1990 per capita incomes. The countries with low reserves in 1981 raised them by larger amounts than the countries with high reserves, and there is a weak but positive link between the sizes of the changes in reserves and per capita incomes; countries with high incomes added more to their reserves. But equation (7) shows that the changes in reserves did not greatly alter the relative positions of the individual countries; levels of reserves in 1991 are strongly and positively correlated with levels of reserves in 1981.

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Table 4 Total Reserves of the Developing Countries, Except Gold (billions of SDR)

								IMF Credit & Loans Outstanding, 1992	
Country Group	1981	1984	1987	1989	1990	1991	1992	Billions of SDR	Percent of Quota
Developing countries	137.0	170.2	129.4	153.2	172.8	213.8	260.0	27.8	51.8
Africa	10.3	6.7	7.1	9.0	11.6	14.1	12.9	5.7	69.3
Asia	30.4	56.1	44.0	64.2	76.1	98.1	128.1	5.9	44.5
Europe	4.9	8.5	7.5	14.4	15.1	15.2	14.7	4.6	39.3
Middle East	58.5	58.4	44.6	41.0	36.7	40.5	42.7	0.4	4.6
Western Hemisphere	32.8	40.5	26.2	24.6	33.3	45.9	61.7	11.0	97.7

Source: International Monetary Fund, *International Financial Statistics,* 1992 Yearbook, February 1983, and May 1993; data exclude Taiwan.

Table 5 Total Reserves of the Developing Countries Measured in Weeks of Imports

	Regional Aggregates		**Regional Averages[a]**	
Country Group	1981	1990	1981	1991
Africa	7.0	11.6	9.4	15.7
Asia	11.1	19.9	13.1	17.3
Middle East	25.7	22.9	21.9	24.0
Western Hemisphere	16.1	21.8	17.5	26.2
Low Income	—	—	11.1	18.1
Lower Middle Income	—	—	14.9	21.8
Upper Middle and High Income	—	—	17.3	19.8

Source: Table A-1 and International Monetary Fund, *International Financial Statistics,* 1992 Yearbook.

[a] Unweighted averages for individual countries listed in Table A-1; some countries' figures for 1991 pertain instead to 1989 or 1990.

A number of developing countries are still short of reserves. Of the 24 African countries covered by the averages in Table 5, 12 had reserves smaller than three months of imports, and 11 other countries were in that same situation. The numbers were much higher in 1981, however, when 19 African countries

and 16 other countries had reserves smaller than three months of imports. Therefore, I find it somewhat hard to argue that there is an acute shortage of reserves or that the global stock is very badly distributed.[14]

A case can still be made for SDR creation, along lines set out above. It would be a way to give the low-income countries the extra degree of freedom they presently lack because they cannot borrow freely. I would be surprised, however, if the low-income countries held onto the SDRs, and they should not be made to do so by reinstating the reconstitution requirement, as Williamson suggested a decade ago.[15] That would do them little good and would reduce the usefulness of the SDR itself, and it is not apt to win the support of those who dogmatically oppose SDR creation because they fear inflation, even when aggregate demand is deficient in the whole world economy.

A stronger case can be made, however, for taking rather different steps to help the developing countries. Although reserves and reserve credit are not perfect substitutes, it may be more fruitful to focus primarily on making reserve credit more readily available than raising the stock of reserves. Two reforms would do that.

First, the International Monetary Fund should reverse the silly decision taken several years ago, which attached full-fledged conditionality to the use of the Compensatory and Contingency Financing Facility (CCFF). That facility was established in 1963 to help commodity-producing countries offset temporary fluctuations in their export earnings due to fluctuations in commodity prices. It was known at the time as the Compensatory Financing Facility (CFF) but was extended in 1988 to deal with balance-of-payments problems caused by other adverse shocks (e.g., an increase in debt-service payments resulting from an increase in world interest rates). The decision to create the CFF reflected in part the desire of the developed countries to forestall a proliferation of commodity agreements, which ran the risk of

14 When the FONDAD conference discussed the first version of this paper, critics raised two objections (1) computing the ratio of reserves to imports may not be the best way to measure the adequacy of reserves; (2) increases in the ratios for some low-income countries are the result of severe import compression due in turn to low export earnings and high debt-service payments. Both points are valid. The first, indeed, restates a point made early in this paper, that a country's need for reserves depends on the variability of the flows across the foreign-exchange market, not on the level of imports, and I made the same point years ago; see Peter B. Kenen and Elinor B. Yudin, "The Demand for International Reserves," In: Review of Economics and Statistics, 47, 1965. The second point amounts to warning that the apparent improvement in the reserve positions of the low-income countries. measured by their ratios of reserves to imports may be a statistical illusion; checking the numbers again, I have found cases of this sort, but they do not account fully for the general result reported in the text.

15 John Williamson, "A New SDR Allocation?" Policy Analyses in International Economics 7, Institute for International Economics, Washington, 1984.

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propping up commodity prices at unsustainable levels. To substitute effectively for those agreements, however, the CFF was designed to provide financing automatically, whenever a commodity-producing country experienced a temporary shortfall in its export earnings. By making access to the CFF strictly conditional, like access to ordinary drawings on the Fund, the Fund made the facility virtually redundant and broke an implicit contract with the developing countries, which gave up their quest for commodity agreements in exchange for liberal access to the CFF. The decision was especially harmful to the poorest countries, which tend to depend most heavily on commodity exports and can least readily afford to cope with fluctuations in their export prices by holding large reserves.

Second, the Fund should encourage its members, especially those that experience large capital inflows, to build up their reserves by earmarking extra credit facilities for those countries' use. This scheme could be linked with one I proposed some years ago.[16] The Fund might administer "shadow" conditionality in respect of member countries that look to be prospective users of Fund credit:

> Under Article IV, sec 3(b) of the Fund agreement, the Fund engages in an annual consultation with each member. These consultations afford the Fund an opportunity to "exercise firm surveillance over the exchange rate policies of members," but they range widely over current problems and policies. In the course of these confidential consultations, and more frequently when necessary, the staff of the Fund should make known its views about the member's balance-of-payments situation and the policy changes, if any, that would be required to correct it. Its views should be offered to surplus countries as well as deficit countries.

But I carried the argument further. When a country is seen to be at risk of running a serious balance-of-payments problem, the staff of the Fund should solicit a "provisional" letter of intent, describing the policies the country would follow to deal with its balance-of-payments problem. The letter of intent would describe the policies that the country planned to follow in light of its current views about its balance-of-payments position, as well as those it would adopt if the situation began to deteriorate. The latter should be deemed to represent the policy commitments that the country would make when it sought to use Fund credit. If the staff of the Fund was not satisfied with the country's plans, it would ask the country to revise the provisional letter of intention. If the staff did not request revisions, the country would have the right to expect that the staff would recommend approval if the provisional letter of intent became a formal letter of intent, submitted with an

16 Kenen, "Financing, Adjustment, and the ... Fund", pp. 69-70.

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application for a drawing. Provisional letters of intent might also be reviewed by the executive board of the Fund, and if it found fault with them, it could make representations to the countries submitting them. The countries would then know that they could not expect to draw on the Fund unless they revised their policy plans.

This process could be adapted and extended to meet the special needs of countries experiencing very large capital inflows. The staff of the Fund could recommend that such countries undertake to build up their reserves. The target could be formulated in flow or stock terms, as an annual rate of increase in reserves or a level to be reached by a specified date. Once such targets were agreed, the staff could recommend to the executive board that the countries meeting them be promised supplementary access to Fund credit, above and beyond their ordinary drawing rights. The amounts of supplementary credit would be geared to each country's reserve target. A dollar of extra reserve assets, for example, might "earn" access to an extra dollar of Fund credit, up to an agreed ceiling. The supplementary credit would be made available under the conditions normally applied to drawings in the first credit tranche, without imposing onerous policy conditions; it would be made available pari passu with the use of the countries' own reserves. Countries having access to this supplementary credit would be protected against a sudden reduction or cessation of capital inflows, due to conditions beyond their control, without having to build up their reserves by as much as would be prudent if they could not count on using extra reserve credit.

III. CONCLUSION

The three proposals made in this paper – an SDR allocation, liberalising access to the CCFF, and the earning of extra reserve credit by building up reserves – hardly amount to a full-fledged reform of the international monetary system. More must be done – and now. The International Monetary Fund must seek and receive a larger role in the policy consultations of the G-7 countries, and the framework for those consultations must be broadened to take explicit account of the powerful ways in which the G-7 countries affect the entire world economy. The G-7 constitute a "steering committee" for the world economy; they must accept that challenge and the corresponding need for accountability. At some point soon, moreover, the G-7 countries must make a fundamental choice; they have either to lapse back into freely floating exchange rates or move on to a more structured exchange-rate regime. They have tried to defer this choice, hoping to conserve their credibility by avoiding ambitious commitments; their caution, however, runs

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the risk of eroding their credibility.[17] Finally, it is time for the Fund and its members to re-examine the ways in which the Fund obtains and uses resources. If the Fund were based fully on the SDR, in the spirit of Keynes rather than White, there would be no need to add to its resources periodically, and it could start to serve as an important supplier of reserves, not merely a custodian of reserve credit.[18]

The developing countries, however, must not be made to wait until the world is ready to deal with these issues, nor should they be told to wait until it has found ways to deal with the problems of Central and Eastern Europe. Some steps can be taken now, including the three proposed in this paper. Those three should, in fact, be treated as a package, because they address different needs. The low-income countries would be the main beneficiaries of SDR creation and of freer access to the CCFF. The middle-income countries would be the main beneficiaries of access to reserve-related supplementary credit.

17 See Peter B. Kenen, "Managing Exchange Rates", Council on Foreign Relations, New York, 1989.

18 See Jacques J. Polak, "Thoughts on an International Monetary Fund Based Fully on the SDR", IMF Pamphlet Series 28, Washington, 1979, and my "Financing, Adjustment, and the ... Fund", pp. 61-68.

STATISTICAL APPENDIX

Table A-1 Reserves and Per Capita Incomes in Developing Countries

Region and Country	Reserves Measured in Weeks of Imports		Income Per Capita in 1990 dollars
	1981	1991	
Africa			
Burkina Faso	10.9	42.9*	330
Burundi	19.8	29.7	210
Cameroon	3.1	0.8**	960
Central African Rep	38.0	39.1*	390
Cote d'Ivoire	0.4	0.4*	750
Ethiopia	18.8	1.0**	120
Ghana	6.8	14.2*	390
Kenya	6.2	3.4	370
Madagascar	2.5	33.0*	230
Malawi	7.1	11.3	200
Mali	2.5	12.0*	270
Morocco	2.7	23.5	950
Niger	10.7	15.3**	310
Nigeria	9.7	35.3**	290
Rwanda	31.8	18.7	310
Sierra Leone	2.5	3.1	240
South Africa	1.5	2.5	2530
Tanzania	0.8	9.1	110
Togo	18.2	31.4*	410
Tunisia	7.4	7.9	1440
Uganda	4.5	17.2	220
Zaire	11.8	13.4	220
Zambia	2.3	8.1**	420
Zimbabwe	5.2	3.7**	640
Asia			
Bangladesh	2.7	19.5	210
China	12.2	36.3	370
India	15.8	9.2	350
Indonesia	19.6	18.6	570
Korea	5.3	8.7	5400
Malaysia	18.4	15.4	2320
Nepal	28.5	27.2	170
Pakistan	6.7	3.2	380
Papua New Guinea	16.3	10.4	860
Philippines	12.7	13.2	730
Singapore	14.2	26.8	11020
Sri Lanka	9.2	11.7	470
Thailand	9.0	24.2	1420

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Table A-1 (continued)

Middle East			
Egypt	4.2	33.7	600
Israel	18.0	19.8**	10920
Jordan	17.9	17.1	1240
Saudi Arabia	47.5	25.2**	7050
Western Hemisphere			
Argentina	18.0	58.6**	2370
Bolivia	5.3	5.9	630
Brazil	14.3	17.2**	2680
Chile	26.3	49.8	1940
Colombia	47.4	63.9	1260
Costa Rica	5.7	25.8	1900
Dominican Rep	7.0	11.6	830
Ecuador	14.6	20.0	980
El Salvador	3.8	10.6	1110
Guatemala	4.6	22.7	900
Haiti	2.7	2.4	370
Honduras	5.5	6.2	590
Mexico	8.8	17.1**	2490
Paraguay	69.9	41.4	1110
Peru	17.9	30.3	1160
Uruguay	13.6	11.1	2560
Venezuela	32.4	50.1	2560
Averages			
Africa	9.4	15.7	512
Asia	13.1	17.3	1867
Middle East	21.9	24.0	4952
Western Hemisphere	17.5	26.2	1496
Low Income	11.1	18.1	326
Lower Middle Income	14.9	21.8	1214
Upper Middle & High Income	17.3	19.8	5246

Source: International Monetary Fund, *International Financial Statistics,* Yearbook 1992 and May 1993, and World Bank, *World Development Report,* 1992.

The countries included in this table are those with populations larger than 2.5 million for which data on reserves and on incomes per capita were published in the sources listed above. (Reserve statistics were available for most IMF members, but not in weeks of imports, because of long lags in publication of the requisite import statistics.)

* Data for 1989.

** Data for 1990.

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Table A-2 Regression Equations

1991 Reserves (in weeks of imports) on 1990 Incomes Per Capita (in thousands of dollars):		
(1) All Countries Except Four with Highest Incomes:[1]		
R Squared	0.056	
Number of observations (degrees of freedom)	54	(52)
Constant term	15.510	
Coefficient on income per capita	4.719	
Standard error (t statistic)	2.692	(1.753)
(2) Low Income Countries:		
R Squared	0.007	
Number of observations (degrees of freedom)	28	(26)
Constant term	15.412	
Coefficient on income per capita	8.187	
Standard error (t statistic)	18.964	(0.432)
(3) Other Countries Except Four with Highest Incomes:		
R Squared	0.084	
Number of observations (degrees of freedom)	26	(24)
Constant term	10.744	
Coefficient on income per capita	7.198	
Standard error (t statistic)	4.864	(1.480)
(4) Africa		
R Squared	0.091	
Number of observations (degrees of freedom)	24	(22)
Constant term	19.543	
Coefficient on income per capita	−7.476	
Standard error (t statistic)	5.027	(1.487)
(5) Asia and Western Hemisphere Except Four with Highest Incomes:		
R Squared	0.122	
Number of observations (degrees of freedom)	30	(28)
Constant term	14.503	
Coefficient on income per capita	7.097	
Standard error (t statistic)	3.594	(1.975)

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Table A-2 (continued)

Change in Reserves, 1981 to 1991, on Income Per Capita and 1981 Reserves:

(6) All Countries Except Four with Highest Incomes:		
R Squared	0.105	
Number of observations (degrees of freedom)	54	(51)
Constant term	8.273	
Coefficient on income per capita	2.776	
Standard error (t statistic)	2.232	(1.244)
Coefficient on 1981 reserves	–0.306	
Standard error (t statistic)	0.134	(2.287)
1991 Reserves on 1981 Reserves:		
(7) All Countries:		
R Squared	0.3402	
Number of observations (degrees of freedom)	58	(56)
Constant term	10.824	
Coefficient on 1991 reserves	0.658	
Standard error (t statistic)	0.123	(5.374)

Source: Data from Table A-1.

1 Israel, Korea, Saudi Arabia, and Singapore.

Comment on "Reforming the International Monetary System," by Peter B. Kenen

Percy S. Mistry

Reminding us, as John Williamson did last year, that any reform of the International Monetary System (IMS) at the present time is best aimed at being modest rather than ambitious, (for the same depressingly familiar reasons), Peter Kenen uses his introduction to set the stage for reviving proposals which are incremental and, for that reason, offered as more acceptable. The pragmatic flavour of the diagnosis can hardly be argued with: but one wonders whether such fatalistic acceptance of minimalism in the name of pragmatism, may not lead to self-fulfilling prophecies where outcomes are concerned. It is now fashionable, especially among the battle-weary, to believe that, in the face of acute introversion coupled with extraordinary inaptitude and progressive paralysis on the part of a particularly sorry crop of G-7 governments, there is no prospect of reforming the IMS in the way that substantially changed global circumstances demand.

I find it intriguing that in the same breath with which we lament the incongruity of relying on the vestigial institutional framework of an IMS originally designed in the 1940s to cope with the realities of the 1990s, we make ourselves believe that there is no point in being too bold about the design or agenda for reform.[1] In doing so I wonder if we are not diminishing prospects for the kind of reform that is indeed needed in the IMS. In pointing out that anomaly I do not argue in favour of reviving the 1970s fashion of tilting at policy windmills – even though the wide ties and bell-bottomed trousers characteristic of that era appear to be in vogue again! But is it completely out of the question to exert sustained intellectual pressure on G-7 governments to have them treat the IMS as something more than a vehicle for achieving expedient short-run political objectives each time a crisis occurs?

That said, three important points are embodied in what Kenen says which should not get lost during our deliberations on the IMS:

1 Clearly the situation is not quite as bad as that. The IMS has been modified in bits and pieces (invariably on a too little too late basis) using jerry-built structures since the breakdown of the Bretton Woods Arrangement in 1971.

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- developing countries have a major stake in strengthening the multilateral trading system through GATT (although the unexplicated corollary to that assertion is that they are unlikely to benefit as much as they might without essential reforms in the IMS);
- the G-7 countries are prone to "innovate and improvise when it suits their purposes" even incurring the risk of damaging the IMS as they appear to have done most recently with their twisting the IMF (and World Bank) out of shape to cope with the problem of Russia;
- there remains an awkward asymmetry after the excesses of the 1980s in letting monetary policy in the G-7 countries bear too much of the brunt of domestic adjustment to self-inflicted damage with profound implications for exacerbating the malfunctioning of the IMS. Unwillingness in the post-Reagan-Thatcher era to bring fiscal policy sufficiently into play has had significant consequences. For example Germany's choices in financing the higher than anticipated costs of unification have destabilised the EMS and forced much higher costs on its EC neighbours (and on the rest of the world) than were strictly necessary. The costs incurred by the U.S. and U.K. in making similar choices to avoid the political pain of corrective fiscal policy have also had significant domestic and international implications.

These choices, of course, circumscribe the room for manoeuvre open to developing countries in adjusting involuntarily to global shocks induced by the G-7's domestic policy failures (as opposed to those caused by market cycles influencing the supply, demand and price of tradables). Developing countries have even less influence over such shocks than over market-induced ones. The present IMS fails to cushion those shocks as it is ostensibly supposed to. Worse still, the system occasionally behaves in ways that exacerbate their effects (as in the case of the debt crisis). Part of the case for reform of the IMS rests on the need to rectify those two shortcomings. The other arguments for reform concern the issues raised by Kenen (and earlier by Williamson), i.e. the need for an IMS which:

1. enables the provision of sufficient liquidity through reserves and access to reserve credit (reserve substitutes) to underpin the stability (and credibility) of exchange regimes and permit the steady expansion of world trade and growth; and,
2. facilitates the flow of investment finance in the "right" direction without incurring the risk of repeated market failure (of the kind that last occurred in the 1980s) based on the cumulative effects of misperceived investor/lender expectations, herd instincts, unregulated (and uninformed) competition within the system and imperfect information.

The paper's discussion on reserves in an environment of increasingly mobile capital flows and the availability of reserve credit is instructive. It takes the

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Williamson argument [2] about the "creditworthiness constraint" a step further, with useful observations about why: (i) reserve credit is not a perfect substitute for reserves, and (ii) the use of such credit under stress involves less flexibility and higher costs than the use of owned reserves.

Drawing the obvious links between the need for reserves with that of access to international capital markets, Kenen examines patterns of resumed capital flows to developing countries claiming good news in "several" developing countries of Latin America and Asia (I am sure he means East Asia when he refers to South Asia) most of which have increased their reserves as a result. He underlines the importance of countries benefiting from such flows striking a careful balance between importing real resources, accumulating reserves and avoiding the monetisation of reserve accumulation, pointing out the difficulties that some developing countries face in sterilising reserves because of the limitations of their internal capital markets. Consequently they are confronted with the "unpleasant options" of non-accumulation of reserves, exchange rate appreciation or monetisation and money-supply led inflation.

The paper highlights the increase in reserves of developing countries between 1989-92, including those of low-income African countries although many of these still had absolute levels of reserves (relative to imports) which were low. Using this evidence, Kenen concludes that it is hard to make the case that there is now an acute shortage of reserves or that reserves are globally maldistributed. That overstretched conclusion does not appear supportable on the basis of the evidence Kenen presents. Though the reserves position may be marginally better (especially for Africa) than it was through most of the 1980s it is hardly comfortable in any sense.

Rather than an SDR emission to increase reserves Kenen prefers to argue for making reserve credit more readily available to developing countries through two specific reforms:

- increasing access to the Compensatory and Contingency Financing Facility (CCFF) of the IMF by dropping conditionality requirements; and,
- encouraging countries enjoying large capital inflows to accumulate reserves by matching their increases with increased (supplementary) access to reserve credit beyond their normal drawing rights and employing a form of "shadow conditionality", the precise exercising of which is outlined in some detail.

The paper's abrupt end with those proposals leaves one not so much with a sense of an unfinished meal but of being served with only half the *hors*

2 "International Monetary Reform & The Prospects for Development", J. Williamson. In: "Fragile Finance: Rethinking the International Monetary System", edited by J.J. Teunissen, FONDAD, 1992.

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d'oeuvres coupled with a vague notion of internal contradictions in Kenen's own arguments. To dispose of the latter issue first, I was struck by the contradiction between paper's earlier arguments about the costs and loss of flexibility in using reserve credit (as opposed to own reserves) and both its suggestions leaning in favour of increasing access to reserve credit rather than towards simply increasing own reserves (e.g. through an SDR emission). Secondly, I found it odd that there were no suggestions in favour of creating innovative synthetic instruments (either capital markets or special deposits held with the IMF or Multilateral Development Banks) which would enable countries without much "sterilisation capacity", because of domestic capital market conditions, to enhance such capacity and minimise the other less pleasant consequences of reserves accumulation.

But of far greater concern to me (this was the same difficulty I had with the Williamson paper last year) was the absence of a sufficiently clear idea of:

- What exactly it was about the IMS today that Kenen saw as being deficient insofar as the developing countries were concerned and how his two suggestions addressed those deficiencies. If, as he seems to contend there is no acute shortage of reserves why focus on measures to increase access to reserve substitutes?
- What in Kenen's experienced view might constitute a comprehensive agenda broken up realistically into short, medium and long-term measures to correct those deficiencies? Assuming his two (sensible) but in my view not terribly powerful suggestions were implemented quickly what would he follow these up with? Or would he rest content with just those changes for a while?
- What should be done to implement a more comprehensive reform agenda in a phased evolutionary manner which would address sensitively and responsively the political difficulties and obstacles imposed by the major countries to such reforms? Or is that irrelevant because the times do not permit the luxury of such thought?

Deficiencies in the IMS (seen from the viewpoint of developing countries) were implied by allusions to previous tired arguments from the 1970s (about the SDR-Aid Link, etc.) rather than explicated from a fresh and clear perspective of what it was about the IMS in the 1990s that failed to meet the legitimate need (not the previous wilder demands) of developing countries; taking into account of course that the circumstances of developing countries have changed dramatically in the last two decades.

An approach to the development of a comprehensive, coherent agenda was finessed by an appeal to recognising the realities of present political circumstances in G-7 countries and the implied impossibility of getting attention focused on any worthwhile set of wider reforms.

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It is often assumed that the deficiencies of the IMS are too obvious to require articulation. That may be true for the cognoscenti. It is patently untrue in the case of government officials and policymakers who influence decisions about the IMF's functioning. I believe therefore that it is essential for a powerful set of arguments to be developed from first principles by respected authorities, based on widely understood and consensually agreed notions about exactly what is wrong with the present IMS in meeting the needs of developing countries.

Second, it is essential to draw the link between why developing countries are unlikely to benefit fully from a strengthened multilateral trading system or from market-friendly structural adjustment unless the IMS is reformed to cope with its more glaring deficiencies.

Third, it is essential to understand much more clearly how significant departures by the OECD countries from an adherence to market principles in key global markets affect the trading positions of the developing countries and whether they create special pressures which the IMS must attempt to relieve in acceptable ways. These departures are invariably made to suit the domestic political circumstances and convenience of the OECD countries (and their private sectors and labour unions). They affect global markets for labour, agricultural products, minerals, services, and a variety of manufactures in which developing countries have now established a strong competitive position (e.g. textiles, consumer electronics, etc.)

Fourth, it is essential to understand much better than we do now, the vulnerability of developing countries to external shocks resulting from the policy failure of major OECD countries, rather than from market failures, and to examine how well the IMS functions in insulating these shocks or in helping the victims cope with post-shock traumas.

Apart from developing arguments for reforming the IMS around these four building blocks, it is perhaps time to recognise that discussions of the IMS with reference to developing countries *en bloc* are becoming increasingly meaningless. It is of course a commonplace to assert that developing countries are a far less homogeneous group than they were when the progenitor of the present IMS was first designed in 1945 or even from when Bretton Woods broke down in 1971 only to be held together by string and cellotape thereafter. Yet it should be obvious that the reserve requirements, liquidity needs and investment financing needs of small and large economies in East Asia, South Asia, Central Asia, South America, Central America and the Caribbean, North Africa, sub-Saharan Africa, the Middle East, Eastern & Central Europe and the former Soviet Union (FSU) are as different as chalk and cheese. One might argue that even regional distinctions are too aggregate to be meaningful although it seems to me that it may well be possible to generalise meaningfully at the regional level.

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Taking the argument further, as intra-regional trading blocs are becoming more a reality, is there not a case for considering some transformation of the IMS to be more flexible and responsive to regional liquidity and investment interests using regional resources?

Would it not, for example, be sensible to consider African liquidity and reserve requirements (as well as exchange rate policy and the trading regime) in the context of facilitating greater intraregional trade and continental integration, especially with the emergence of post-apartheid South Africa, rather than in terms of relationships with the rest of the world – a situation which has worked to Africa's increasing disadvantage as it becomes more marginal in the global trading system?

Should we not be thinking of more imaginative arrangements and a different nexus between the IMF (or regional mini-IMFs) and the regional development banks in backstopping regional liquidity arrangements and investment flows than we have been inclined to do so far?

Part of our problem in thinking about reforming the IMS seems to be that we are trapped by being at the wrong starting point, i.e. we think about reforming the IMS from the stale view of the institutional (and instrumentation) framework we have inherited from a now defunct Bretton Woods arrangement rather than from the fresher viewpoint of global and developing country needs. In other words, our approach to reform is supply-side rather than demand-need driven.

At a global level should we attempt to define clearer roles for the IMF and the World Bank in the IMS instead of having their roles being driven by events such as the oil-shock in the 1970s, the debt and adjustment shocks of the 1980s and the "unipolarisation" shock of the 1990s?

Finally, international finance is now dominated by the private financial system in which officially directed flows of finance are insignificant. Ought we not to be thinking about a new and different nexus between the official and private segments of the IMS not simply in catering more responsively to developing countries but to the need of the world as a whole?

The privilege of being a commentator rather than an author is that one can indulge in asking the big questions while being relieved of the responsibility of providing the big answers. Peter Kenen is far more accomplished *artiste* in the latter department than I am ever likely to be. So I shall stop here without pushing my luck further, leaving him with the thought that we await bolder and more colourful strokes of his brush across a wider canvas than he has chosen for this particular paper.

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Comment on "Reforming the International Monetary System," by Peter B. Kenen

Gerald K. Helleiner

Peter Kenen's paper is very good – as far as it goes. It has very modest aspirations.

Kenen suggests some ways of meeting the liquidity needs of the developing countries: two of these ways are old; one is new. Subject to some caveats, that I will offer below, his suggestions are sensible, and I agree with them.

I particularly welcome Kenen's clarity as to the distinction between "owned reserves" and reserve credit – and, implicitly, between such "reserve credit", which provides liquidity, and upper credit tranche IMF credit which, however useful, because of its transactions costs and delays, does not.

I would have preferred more explicit recognition on his part of the typically greater "needs" of developing countries for liquidity – both on traditionally agreed grounds and on the new capital-flow related ones. Whether reserves are held or not, and whether they rise or fall over any particular period, there are likely to be very high returns from the provision of increased liquidity for the developing countries. But the cost of acquiring this liquidity, in the particular form of owned reserves, is also very high in terms of opportunity costs. That reserves have risen over time does not indicate anything about the cost of the acquisition of these increased reserves. That cost has frequently been very high – in terms of severe and unsustainable degrees of demand restraint and import compression.

Low-income countries are closer to the "survival margin" than are richer countries. Insurance is a luxury good. It has never been useful to recommend to the poor that, buffeted as they are by severe shocks, they should buy insurance policies! Low-income countries are subject to export shocks that are typically larger than those of other countries – both price and volume shocks, and these two do not offset one another at the country level. These countries also incur higher costs when they borrow and/or have limited access to credit. Moreover, they typically can enjoy fewer scale economies in reserve management. In short, there is no reason to believe that the low-income countries in Sub-Saharan Africa that, on Kenen's evidence, have increased their reserves are in an acceptable state of macroeconomic balance, or are "on their appropriate demand functions". Such demand functions are

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the product of an international income and wealth distribution with which these countries are certainly not content.

The utilisation of savings for the purpose of building foreign exchange reserves in the 1980s has been at the expense of investment and levels of welfare among extremely poor members of the global community. These low-income countries have always been and remain particularly vulnerable to turbulence, disorder and uncertainty of the kind that has characterised the global economy during the last two decades. The most glaring shortcoming of the global liquidity system in the 1970s and 1980s has been its failure to deliver expanding access to low conditionality credit for those countries with limited access to commercial credit in the face of growing trade and international payments, and growing international economic turbulence.

Let me first address those recommendations with which I agree. Let me offer wholehearted support for Kenen's proposed reform of the CCFF, that which Sidney Dell called – in its current "silly" version – the "fifth credit tranche". There should certainly be a return to greater automaticity of access to this facility, as Kenen suggests. But Kenen's reforms do not go far enough – for three reasons:

1. Access to the CCFF is IMF quota-related. CCFF drawing rights have therefore typically fallen far short of shortfalls. The oil facility in the 1970s provided a temporary and ad hoc substitute for a more satisfactory CCFF; but it has long since vanished from the scene. Access rights should more closely approach actual shortfalls and are probably best expressed in terms of a pre-stipulated percentage of shortfall rather than as a percentage of quota.
2. Access rights should also be related to forecast errors, i.e., shocks that are not simply the product of one-year shortfalls. More automatic, and therefore faster, access on a contingency basis is required. Provided that these access rights are still formula-based, neither such contingency financing arrangements nor shortfall-related rights will generate any moral hazard.
3. The CCFF still charges the same interest rate to all IMF borrowers. Low-income countries (those that benefit from the SAF and ESAF) should receive concessional interest rates on CCFF finance in the same way as they do for other IMF finance.

This third point raises the more general issue of the special needs of the very low-income countries. The concessional interest rates they have been receiving through the Trust Fund, the SAF and the ESAF have not been fully institutionalised and are subject to periodic renegotiation every two or three years. It is surely time that, as in the case of IDA lending, very low-income countries should be able to count on concessional interest rates in whatever borrowing they undertake from the IMF under whatever facility. Moreover,

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the financing of interest subsidies in the IMF should be more equitable than at present. The U.S. and some other countries are at present "free-riding" on the generosity of other donors. One promising option for such financing is the sale of some of the IMF's vast stock of gold. More fundamentally, low-income countries most require more IDA programme lending together with contingency clauses therein. The World Bank would then "lead" financing efforts for these countries, as they certainly should; and, with adequate contingency finance through IDA programmes, the IMF could retreat to a technical assistance role.

Kenen's suggestions concerning an SDR allocation also win my support. Again, however, they do not take into account the peculiar needs of the very low-income countries. These countries will be unable to use SDRs that are issued on the present basis because of the commercial interest rate that must be paid on them. A way must be found to ensure that the very low-income countries can acquire increased liquidity, that they can afford, as their needs expand. There are many institutional devices through which a concessional interest rate on future SDR allocations can be financed, again including IMF gold sales.

I have no quarrel with Kenen's new suggestion for additional rights. It seems to me, however, that symmetry would require that some form of "supplementary finance" for countries with problems other than those created by private capital flow would also be appropriate. It might also be appropriate to "target" reserves for primary producing countries that experience large export shocks, with further IMF credit offered once certain target levels are achieved. "Shadow conditions" and provisional letters of intent could assist primary producing countries as well as those vulnerable to private capital surges. Incentives can always be expected to help countries to meet liquidity targets. Why should they not be provided to those with "old" problems as well as those with new ones?

Kenen's approach has been to tinker with the system as it is. I would have preferred a paper that dealt with the potential for more fundamental reform and the rethinking of first principles. Kenen opts for tinkering because "there is almost no interest today in any reform of the monetary system". I find this a breathtaking observation. It appears to offer a possible new element, although it is actually quite old, within the Washington consensus: arguments should be weighted by the income of those making them. With apologies to another author, let me offer some comment.

"The poor complain. They always do. But that's just idle chatter.
Our system brings rewards to all, at least to all who matter."

I reject Kenen's premise that no one is interested. I accept a related, more accurate, proposition: that the G-7 powers are not at present very interested in more fundamental reform and therefore that such reform is not in

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prospect. I cannot accept his view that, because for developing countries the trade issues may be more important, they should not be interested in these international monetary issues. Why must they choose? Does the U.S. do so? This conference was intended to discuss the need for reform in the interest of all members of the global community. Personally, I have always preferred population weights to income weights.

I therefore regret that Kenen did not address a number of deeper issues.

First, the "global need" for liquidity needs to be redefined and its provision automaticised. There should be a formula base for IMF quota expansion and/or SDR issues, rather than continuing to debate on the basis of political negotiation of what is an appropriate degree of expansion.

Second, like Percy Mistry, I think in the financial sphere there is an overconcentration in Washington. We do need a global system, but we may want to decentralise responsibilities. What about the potential for regional funds and/or the regional development banks; and the pros and cons of a deconcentration of the international monetary and financial system? If we were to begin again, would we construct the centralised system as it now exists?

Third, there is also a clear need for more "bridge finance" – not simply for "systemic transition" in Eastern Europe and the former Soviet Union, but for a variety of other purposes as well.

Fourth, what about the developing countries' interest in problems emphasised elsewhere in this conference, those created by international private capital flows, and their possible support for the Tobin proposals for putting more "sand in the wheels".

And, fifth, is anyone content with the current macroeconomic governance of the global economy? Must there not be better provision for the representation in such governance of countries other than the members of the G-7?

There is much that Kenen, with his income-weighted "realism" has left out.

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Comment on "Reforming the International Monetary System," by Peter B. Kenen

Ariel Buira

Professor Kenen asks what changes in the monetary system might most directly meet the needs of developing countries. To be realistic, he adds, we must confine our attention to those changes in the system that do not impose unacceptable costs on industrial countries and do not crowd out other forms of development assistance. He regards this last constraint as daunting, since the governments of the industrial countries are deeply preoccupied with their own economic and social problems. But one may well ask whether the objectives of the developing countries generally differ from those of industrial countries. I would submit this is not necessarily the case, as there are a number of improvements in the international monetary system that would benefit all countries. For the sake of brevity I shall only refer to:

1. The exchange rate system.
2. The adjustment process and the role of the Fund.
3. International liquidity.

This is not to say that there are not several other topics that would merit careful review.

The exchange rate system

The stability of the exchange rate system is fundamental to the development of world trade and investment flows. Exchange rate crises introduce uncertainty and are thus disruptive of world trade, particularly for developing countries that may not have ready access to hedging techniques. More importantly, exchange rate misalignments prevent growth and foster protectionism.

There can be little question that unsound and inconsistent policies give rise to volatility and misalignments of the exchange rates for major currencies. Exchange rate stability depends on current and prospective macroeconomic policies and performance.

The recent European exchange market crisis has demonstrated that massive financial resources can be rapidly mobilised in international capital markets to bring enormous pressures against an exchange rate parity,

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overwhelming any plausible official intervention if this is not supported by other policy actions.

For developing countries as for the world, exchange rate alignment and stability of the major currencies is important. So, the improvement of the exchange rate system would be of benefit to them. This is consistent with Professor Kenen's remark that the developing countries should give priority to strengthening an open trading system. But of course, improvements in policy coordination and thus in the exchange rate system would also benefit industrial countries.

More than aid, most developing countries need an international economy that is growing, stable and generally in good working order. Undoubtedly, as the recent events in exchange markets show, the present system has not achieved an adequate degree of policy coordination among industrial countries. The stability of the exchange rate system depends importantly on whether a high degree of convergence in the economic performance and the domestic policies of the major countries can be achieved and maintained. Such convergence will reduce the conflicts between domestic economic objectives and the objective of exchange rate stability.

An orderly international exchange rate system requires the willingness and the ability of countries to coordinate their policies. Countries must maintain strong fiscal discipline and avoid divergent trends in actual or expected inflation that could undermine the sustainability of the exchange rate. Strengthening of fundamentals and increased policy coordination have been the stated goals of the G-10 countries and of the EC countries over the last decade. However, the results to date leave something to be desired.

Adjustment process and the role of the Fund

The persistence of large deficits in a number of G-7 countries over long periods of time must be seen as a major shortcoming of the present system. These deficits have the effect of absorbing a significant portion of world savings, contribute to raise international interest rates, discourage investment, and aggravate the problems of debtor developing countries and more generally of capital importing countries. Secondly, countries with large fiscal deficits find that the countercyclical role of fiscal policy is severely limited. This had led to the virtual abandonment by many countries of fiscal policy as a tool of stabilisation, consequently placing excessive reliance on monetary policy to achieve both internal and external balance.

A third point in the adjustment process and one which is a major shortcoming of present arrangements, is that there is no provision to encourage adjustment by surplus countries or by reserve currency countries. Consequently, the burden of adjustment is not shared symmetrically between

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surplus and deficit countries, (which would reduce the efforts required of the latter) but falls entirely on deficit countries.

A fourth point relates to adjustment in developing countries. In the conditions described above and in the context of a semi-stagnant international economy, which for most developing countries means rising protectionism and declining terms of trade, debtor developing countries turn to the IMF for assistance. Now the theory is that the IMF will provide financing to facilitate the adjustment process. However, Fund programmes are generally underfinanced. The experience of Latin America over the last decade has been that countries had to undertake adjustment while sustaining massive net negative transfers of resources abroad. This lengthens the time necessary to solve the debt crisis and imposes very great costs in terms of investment, lost output and employment. It also adds greatly to the political difficulties of achieving a successful adjustment. The result has been a far cry from the model of "adjustment with growth". No wonder that, in recent years, between half and two thirds of the programmes have broken down before completion.

The original Bretton Woods Conference gave the Fund wide responsibilities which included: (Article I)

i. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
ii. To promote exchange stability, to promote international monetary cooperation and to maintain orderly exchange arrangements among members.
iii. To make the resources of the Fund temporarily available to members (under adequate safeguards), thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

My comments on the adjustment process and exchange rate system are an indicator of how successful the Fund has been in attaining these objectives.

International liquidity

Mr. Kenen stresses that since 1981 a substantial and generalised increase in the international reserves of LDCs has been recorded, thus making it "hard to argue that there is an acute shortage of reserves or that the global stock is very badly distributed". Allow me to make some comments in this respect.

Let me start with the figures themselves. Mr. Kenen compares the evolution of the ratio of international reserves to merchandise imports in two

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years: 1981 and 1991. We can reach a very different conclusion by using a slightly different base for comparison. Thus, according to IMF figures, by 1992 over 50 per cent of the Fund's total membership had international reserves below 12 weeks of merchandise imports, and over 40 per cent fell short of 10 weeks. The situation would be much worse if debt service payments were included. In addition, the role of import compression in sustaining those liquidity levels should be considered. This shows the fragility of any analysis based exclusively on the use of statistics.

I am convinced that the case for (or against) an increase in international liquidity is more conceptual than statistical in nature. Presently, the world economy is characterised by low levels of economic activity and high unemployment, and prospects in the major industrial economies are not bright. Indeed, except for the United Kingdom, Europe is entering into a recession and is expected to have negative growth in 1993. Therefore, it should be clear that since the present danger is a worldwide recession rather than a renewal of the inflationary process, an allocation of SDRs could make an important contribution to restore demand, economic growth and increase employment.

Stabilisation efforts in important parts of the world, including in particular countries in Eastern Europe, the former Soviet Union, and many small low-income countries in other regions, are currently being put at risk by inadequate levels of international reserves. Moreover, these countries' ability to build reserves to satisfactory levels, as well as to meet the projected growth of reserve demand over the longer term, is heavily constrained by two factors. First, they generally lack access to private international credit markets and face very high costs in earning additional reserves. Secondly, these countries, most of which have already experienced serious import compression in recent years, are not in a position to absorb the economic costs of building up reserves through further import compression, very low rates of economic growth, or reliance on controls on trade and payments.

The high cost of acquiring and holding reserves is particularly harmful in a period of historically low commodity prices and high variability of payments. Tolerating a further compression of imports, when there are other means of at least partially alleviating the reserves constraint, would be in contradiction with any strategy for world economic recovery. In fact, the sustainability and success of economic stabilisation and reform in many of the former centrally planned economies and many developing countries would be considerably enhanced with a new SDR allocation. This would clearly brighten the prospects for the entire world.

As Mr. Kenen points out in his paper, there are some people who oppose an SDR allocation because of its potential inflationary impact. There are no solid grounds for concern on this front, particularly in the case of an

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allocation substantially less than the projected increase of world demand for reserves. [1]

I would like to make two final points on the liquidity issue.

Firstly, as Dr. Witteveen has recently recalled, today international liquidity creation is a consequence of the mostly uncoordinated monetary policies followed by the major industrial countries in the pursuit of their own domestic objectives. The creation of international liquidity results as a residual. Consequently, the major role it plays in the development of the world economy as a whole, is not sufficiently recognised.

Despite its important effects on world economic activity, neither the IMF or any other international body have much influence on its evolution. It goes without saying that the great majority of countries in the world, developing and industrial, have no say in the determination of international liquidity.

Secondly, the current system is not only inefficient, it is also grossly unfair since the benefits of liquidity creation, i.e., the seignoriage of say, an additional $100 billion a year, accrues roughly, by over 50 per cent to the U.S., by some 20 per cent to Germany, and 9 or 10 per cent to Japan, which is a less than equitable arrangement. Not surprisingly, some of these countries are staunch enemies of the SDR.

To conclude, let me briefly comment on the measures Mr. Kenen proposes to support LDCs as an alternative to an SDR allocation. I fully support the suggestion that the decision that attaches conditionality to the use of the IMF's Compensatory and Contingency Financing Facility be reversed. Since the shortfall is temporary and due to causes beyond the control of the country, this decision makes no sense from an economic point of view. This is a position repeatedly supported by LDCs in many fora.

I also find the proposal to give supplementary IMF credit under some circumstances to countries facing a sudden reduction or cessation of capital inflows appealing. In fact, a very similar proposal was put forward by the Mexican government in 1976. Nevertheless, one must be aware that this sort of schemes could carry some dangers as they may lead some countries to excessive indebtedness. One way to avoid this, would be to allow access to this facility only to those countries with solid economic fundamentals.

In closing, I would like to note that I do not see why these two proposals ought to be considered as alternatives rather than complementary to other measures to reform the international monetary system.

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1 Estimates of the IMF based on projections for the growth of world imports in the period 1992-96, and on the assumption that the ratio of non-gold reserves to imports for all countries remains at its end of 1991 value, show that the world demand for non-gold reserves may be expected to rise by 300 to 400 billion SDR over the next five years. An annual allocation of say 10 billion SDRs during this period, would amount to only about 15 per cent of the projected growth in the world demand for reserves. This could hardly have an impact on inflation.

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Mr. Kenen's agenda for reform is far too modest given the magnitude of the problems faced by the world. In my view bolder initiatives are required.

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Floor Discussion of the Kenen Paper

A too timid agenda of reform?

Peter Kenen's reform agenda did not arouse much enthusiasm. Various participants, from developing as well as industrial countries, felt it was "too thin". They were disappointed that Kenen, who has gained worldwide reputation as a thinker on international monetary issues, had not presented a more challenging set of proposals.

Bernard Snoy elaborated on this critique by arguing that the discussion should return to the fundamental point made many years ago by his fellow countryman Robert Triffin of placing the Special Drawing Right (SDR) in the centre of the international monetary system and not in the periphery. He also thought Kenen had not done justice to the compelling arguments for a new SDR allocation made by the Managing Director of the IMF, Mr. Camdessus, since April 1993.

According to Snoy there are three fundamental reasons for a new SDR allocation. First, most developing countries and countries in transition to a market economy will not be able to acquire the additional reserves that they need in the coming years, except at high costs to both the countries concerned and the world economic community at large. "These costs," he said, "in terms of total interest costs, but also in terms of compression of domestic demand and compression of imports, exceed the true economic opportunity costs to the world of creating additional reserves through an SDR allocation."

A second reason is that if one fails to relieve the reserve stringencies of the many countries that are currently engaged in stabilisation and transition efforts, the risk of widespread setbacks or failures will be increased. "It is the argument of the underfinancing of Fund programmes, of adjustment fatigue, which in turn leads to aid fatigue in a very vicious circle." The failure to meet the reserve requirements of countries that are assisted by the IMF would have highly adverse effects on the global economy, Snoy warned.

A third reason is that one should implement the provisions of Article 22 of the IMF, "which is the objective of making the SDR the principal asset in the international monetary system, or, at least, to stop its rapid decline."

Illustrating these three arguments for the case of two categories of countries, the low-income developing countries and the transition economies of Eastern Europe and the former Soviet Union, Snoy observed that various urgent problems will have to be solved in the near future.

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"For the low-income countries – who are faced with very serious structural and financial problems – we have more or less a consensus that we will need a successor arrangement when the current ESAF arrangement expires later this year. But we don't know how this ESAF successor will be financed, and solutions may be harder to find when nearly all the industrial countries have serious budget problems. We may find a way through an SDR allocation. Alternatively, an SDR allocation properly rechannelled could also help to strengthen the reserve position and adjustment prospects of the low-income developing countries," Snoy suggested.

With respect to the transition economies Snoy pointed out that among the Group of Ten countries there is a similar consensus that these economies need a strengthening of their reserve position.

"These economies have to cope with systemic shocks which hamper them in building a market economy and they have much to gain from an increase in reserves. They have very limited access to international capital markets, so they can only compress their imports, or increase their access to industrial countries' import markets. In the present circumstances, however, it is very hard to imagine that these countries could acquire a sufficient amount of reserves through either import compression or market borrowing."

Snoy reminded the meeting that the Group of Ten ministers and governors had agreed last September that the reserve stringencies in the transition economies were such that they presented a threat to the stability of the international monetary system. This recognition of a systemic problem, he believed, could be the basis for a new SDR allocation.

Finally, Snoy observed that the debate about an SDR allocation continued to be clouded by two misunderstandings, which, to his regret, had not been dispelled by Peter Kenen's paper.

"The first is that an SDR allocation needs to be large to have any effect on the reserves of the non-industrial countries, i.e. the developing countries and the transition economies. The second is that by delivering unconditional liquidity and by providing it to countries that do not need it, an SDR allocation contains an inherent inflationary risk. Both these arguments can be tackled by deciding to link the SDR allocation to the acceptance by the industrial countries of a retransferring mechanism which redistributes the SDRs allocated to them. Rechannelling these SDRs through the Fund, while attaching conditionality to their use, would ensure a much more effective use of the SDRs allocated. This is the so-called Belgian proposition of rechannelling the new SDR allocation. It has been made repeatedly by the ministers of finance of Belgium since it was first formulated by Minister De Clercq in 1984."

By means of such a redistribution mechanism, Snoy noted, one would ensure that all of the allocated SDRs would be directly and exclusively used to

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meet systemic needs. They would thus supplement the conditional financing already provided by the Fund through ESAF to the low-income countries, and through the Systemic Transformation Facility to the transition economies. Moreover, new allocations of SDRs would remain available in the system for addressing other systemic problems such as the intervention needs of reserve currency countries under a system of more stable exchange rates.

Mahbub ul Haq said he was surprised "that Peter Kenen had limited his intellectual genius, because he is the leading light in international monetary analysis and we would have greatly benefitted from his analysis of what is wrong with the international monetary system." According to him the IMF has become so marginal to global monetary management, "that it is a cripple now". Most of all, he argued, because it does not have much of a role to play vis-à-vis the major part of the monetary system.

"They always played a role vis-à-vis the developing countries, which had to accept IMF-imposed monetary receipts. But that is less than 10 per cent of global liquidity. The really money management is done by Bundesbank and Federal Reserve Board of the U.S., by Japan, by the Group of Seven, and by the private capital markets. A trillion dollars is flowing across international frontiers every 24 hours at the push of computer buttons. The IMF is being made irrelevant by the policies of the industrial countries;" ul Haq observed.

Subsequently, he raised the question of whether a global monetary institution would still be needed, and, if so, what reforms would have to be made in the IMF to play that role. His own answer was that one has to keep a sustained intellectual pressure for change. "I think it would be very sad if in a forum like this we are throwing in the towel and saying that realpolitik is such that we cannot expect any major changes in the international monetary institutions."

John Williamson, who at a previous FONDAD conference had presented his own agenda of monetary reform, made another suggestion for broadening the agenda. According to him, one of the main points should be to do something in the monetary field to support open trade policies.

"We are living in a world where more and more people are worrying about the export of jobs to – depending on where you are – Eastern Europe, Mexico or East Asia, and, as a consequence, are favouring protectionism. If the concern is the export of jobs, then we ought to be able to think of a way to ensure that this will not happen. What I have in mind is to use some type of arrangement for balance of payments targeting, with sanctions for countries that have excessive surpluses, because as long as Malaysia is increasing its exports, but at the same time is increasing its imports, there is no danger of jobs being lost in the West.

This leads me to think that there is another argument for the sort of balance of payments targets that I proposed in the blueprint for policy

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coordination, which was in the paper I presented at the FONDAD conference last year. I have always thought of these targets as something that is useful to prevent misalignments in the exchange rate system. But this may be an even more important rationale for going down that road: providing the assurance to the public in the industrial countries that their jobs are not going to be exported to developing countries."

Kenen's proposals

Peter Kenen's three proposals – SDR creation, freer access to CCFF, extra reserve credit – excited some critical comments as well.

Delphin Rwegasira disagreed with Kenen's conclusion that most developing countries now have a fairly adequate level of reserves. "These reserves may look quite good, but have partly been the result of very serious import compression," he contended. Given the source of this reserve accumulation he also questioned the sustainability of the current level of reserves.

Rwegasira felt that the international monetary authorities should do much more to meet the needs of, in particular, the low-income countries because, he argued, these countries are highly vulnerable to shocks in the prices of their export commodities and climatic factors like droughts.

"I happened to work in a central bank of a low-income country," Rwegasira explained, "and there I have learned that things like droughts, not to mention the usual deterioration of the terms of trade, can turn a reserve level that looks quite reasonable into a big shortage. Then you can try to juggle with the exchange rate, but there is a very limited range within which the government, or indeed the economy as a whole, can adjust to these kinds of shocks. Given the vulnerability of these countries, and given the opportunity costs of reserves, I would therefore hope that the international monetary system would not only provide adequate levels of liquidity, but also liquidity at low costs."

Helen Junz objected to Kenen's suggestion that the IMF should give developing countries a freer access to its Compensatory and Contingency Financing Facility (CCFF).

"I think that fixing and re-fixing the CCFF is not really even a partial answer," she said. According to Junz the CCFF was instituted to provide financing for problems that were reversible in the short term, but since the short term very easily becomes the medium or the long term, she argued, it was quite reasonable to attach conditionality to the CCFF or other bridge financing mechanisms. Moreover, she stressed, CCFF conditionality was not as strict as Kenen suggested. "There are gradations," she said.

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Kenen's reply

Kenen explained, first of all, why he had substantially restricted his reform agenda.

"I have been asked to write a paper on the most urgent reforms of the international monetary system and ways to improve the access of developing countries to international liquidity, and that's what I have done. I wrote a paper on what I thought to be the most urgent and immediate steps and I did not intend to present a long-term agenda. But yet, even what I am proposing as feasible in the short run may turn out not to be feasible."

Kenen agreed with Bernard Snoy on the need for a new SDR allocation. He had tried very hard, he said, to get his hands on some of the documents of the Fund concerning this matter, but had met with a flat refusal. Nonetheless, he believed that the case made in those documents was strong and he fully endorsed it.

Kenen accepted the criticism that the ratio of reserves to imports is not a good measure of reserve adequacy, and is less relevant today than in the past. "May I say in self-defence," he added, "that already in 1965 I wrote a paper on the demand for international reserves which began with an assault on that measure and went on to say that the appropriate measure was the variability of the balance of payments. And I got some pretty good empirical results in support of that proposition."

He also accepted the criticism that, after having made the case for owned reserves, he had focused much more on reserve credit. Kenen said that in revising his paper he would give more attention to the importance of an SDR allocation.

Though agreeing with Gerald Helleiner's complaint that the interest rates on the SDR were too high for the low-income countries, Kenen strongly disagreed with Helleiner's proposal to lower these rates. "We worked very hard to make the SDR a more attractive reserve asset and one of the reasons why the interest rate was raised was precisely that," he said. Kenen would prefer a different method of reducing the SDR interest rate.

"I would take a more general position and argue that some portion of the development assistance programmes of the industrial countries should be devoted to interest subsidies across the board, not tied to the SDR or any other specific asset. Using ODA for interest subsidies on various sorts of obligations, including the SDR, would be a very effective leverage, but I would not touch the SDR scheme itself. That would be a retrograde step. Just as the restoration of a reconstitution requirement would be a retrograde step."

Finally, Kenen took up the challenge to provide "a very short version" of his long-term reform agenda.

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"First, I have always argued that we must move to a Fund fully based on the SDR. The financing of the Fund should be done by SDR creation, not by quota subscriptions, for both economic and political reasons.

Second, I strongly endorse the notion that the process of G-7 coordination ought to be integrated in some way into the work of the Fund. The instrumentalities and techniques may not be easy to work out, but I fully agree with those who say that present arrangements under which the Managing Director of the Fund comes and goes are utterly inappropriate. The G-7 process must become integrated thoroughly into the work of the IMF.

Third, I have from time to time argued that the whole approach to conditionality needs to be reviewed.

Fourth, I of all people have argued that we should move to a more structured exchange rate system among the major industrial countries, not necessarily moving back to fixed rates, but moving in the direction of a much more explicit system of targetting.

That would be my agenda. These measures are not directed specifically at the developing countries, but I think that the developing countries would benefit from them."

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Globalisation of Financial Markets and Impact on Flows to LDCs: New Challenges for Regulation

Stephany Griffith-Jones with Vassilis Papageorgiou [1]

Introduction

This paper starts by describing recent trends in private financial markets, both globally and to developing countries. Then it analyses the structural changes that have occurred in global private financial markets – particularly resulting from deregulation and liberalisation – and attempts to evaluate their benefits and costs. Based on this analysis, it attempts to define the increase – and change in the nature of – risk, particularly of a systemic type. Special reference is made to risks as they affect LDCs. The paper then reviews some of the main aspects of the supervisory and regulatory response to the changes in financial flows and, above all, to changes in perceived risk which they generate. Finally, conclusions are drawn and policy recommendations made, the latter going from those which are fairly widely accepted (but not implemented) to those which would be more innovative.

I. RECENT TRENDS IN PRIVATE FINANCIAL MARKETS AND IN FLOWS TO DEVELOPING COUNTRIES

Globally, in 1992 borrowing on international capital markets continued its rapid increase for the second year in a row; in 1991, there had been a rapid increase (of 20.7%) in the aggregate volume of international capital flows; in 1992, there was a further increase of 16.2% (see Table 1). In fact, in 1992, global borrowing was at a level 54% above its 1987 level!

Though borrowing on international capital markets by developing countries continued to increase, in 1992 to their highest level since the early 1980s, the growth (at 2.3%) was negligible in real terms according to OECD estimates; it was also far lower than growth in 1991, when developing

1 We thank Luis Gonzalez for very valuable research assistance. Dr Stephany Griffith-Jones is grateful to regulators, who offered her valuable insights, when she interviewed them. The responsibility, however, for her views and ideas as expressed in the paper is hers.

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Table 1 Borrowing on International Capital Markets (billions of US dollars)

Borrower	1987	1988	1989	1990	1991	1992
OECD countries	349.6	413.8	426.5	384.4	457.9	535.7
Developing countries	26.3	22.5	21.8	28.6	46.2	47.3
Eastern Europe	3.7	4.6	4.7	4.6	1.8	1.5
Others	13.3	12.6	13.5	17.3	19.0	25.2
Total	392.9	453.5	466.5	434.9	524.9	609.7
Year-on-year % increase		15.7%	2.8%	-6.8%	20.7%	16.2%

Source: OECD, Financial Market Trends, Vol 54, February 1993, p.7.

countries were reported to have had an increase of 62% in the volume of borrowing on international capital markets, from $28.6 billion to $46.2 billion (see again Table 1). In comparing with the 1987 level, developing countries' borrowing was at a level 80% above its 1987 level. Thus, growth of lending to LDCs has been faster over the 1987-1992 period than that for global flows.

If we examine the share of developing countries' borrowing in the global total, this share first fell from 6.6% in 1987 to 4.7% in 1989, increased to 6.6% in 1990, increased further to about 9% in 1991, but declined somewhat in 1992.

Indeed, it was growth in OECD countries' borrowing which accounted for practically all the rapid growth of global borrowing in 1992, whereas in 1991 LDC borrowing had contributed fairly significantly to that growth.

As in previous years, the main dynamism globally in 1992 did not come from syndicated loans (which remained at approximately the same level as in 1991), but came from growth of securities and non-underwritten facilities (see Table 2).

As can be seen from comparing Tables 3 and 2, developing countries seem to follow similar trends to global ones, with declining importance of syndicated loans (especially marked in 1992), and with sharp increases in securities (particularly important in 1992 in bonds, but also reflecting a continued large increase in equities). It is also noteworthy that non-underwritten facilities (which include Euro-commercial paper) have increased a great deal in 1992, reaching then the same level as equities.

It is worth noting that, according to other sources, such as the World Bank,[2] which have made major efforts to have complete coverage of these new flows to developing countries, the figures for private portfolio flows to

2 See, for example, World Bank "Global Economic Prospects and the Developing Countries", 1993, pp.35-36.

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Table 2 Borrowing of the International Capital Markets (billions of US dollars)

	1988	1989	1990	1991	1992
Securities	234.8	263.8	237.2	321.0	357.2
Loans	125.5	121.1	124.5	116.0	117.9
Committed back-up facilities	16.6	8.4	7.0	7.7	6.7
Non-underwritten facilities [1]	76.6	73.2	66.2	80.2	127.9
Total	453.5	466.5	434.9	524.9	609.7
Memorandum item:					
Year-on-year percentage change	+15.7	+2.8	-6.8	+20.7	+16.2

1 Including Euro-commercial paper.

Source: OECD, Financial Market Trends, Vol 54, February 1993, p.87.

Table 3 Borrowing by Developing Countries (OECD definition billions of US dollars)

Instruments	1987	1988	1989	1990	1991	1992
Bonds	3.1	4.2	2.6	4.5	8.3	14.0
Equities	0.0	0.3	0.1	1.0	5.0	7.2
Syndicated loans	20.1	17.4	16.2	19.8	26.7	16.5
Committed borrowing facilities	1.3	1.3	0.9	2.1	4.5	1.3
Non-underwritten facilities [1]	1.8	1.2	2.0	1.2	1.7	7.9
Total	26.3	22.5	21.8	28.6	46.2	47.3

1 Same as in Table 2.

Source: OECD, Financial Market Trends, Vol 54, February 1993, Statistical Annex.

LDCs are somewhat higher. Thus, according to World Bank recent estimates (World Bank, op. cit.), gross private portfolio flows to developing countries grew explosively since 1989; indeed, these flows which averaged under $6 billion a year in the 1982-88 period, were estimated by the World Bank to have grown to an estimated $34 billion in 1992.

The increase has reportedly gone largely to a few countries in Latin America, where gross equity flows have grown more than tenfold in four

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years (mainly via ADRs and GDRs), from $434 million in 1989 to an estimated $5.6 billion, and where bond financing increased almost fifteen-fold, from $833 million in 1989 to $11.7 billion in 1992 (see Table 4).

Table 4 Portfolio Investment in Latin America, 1989-92 (millions of US$)

Type of Investment	1989	1990	1991	1992[1]
Equity investment from abroad	434	1,099	6,228	5,570
of which				
Closed-end funds	416	575	771	293
ADRs/GDRs	–	98	4,697	4,377
Direct equity investment	18	426	760	900
Bonds	833	2,673	6,848	11,732
Commercial paper	127	0	1,212	840
Certificates of deposit	0	0	670	1,100
Total	1,394	3,772	14,958	19,243

1 Estimated.

Source: World Bank staff estimates.

Though the increase in securities' flows to developing countries (and especially to Latin America) has been impressive, some analysts argue that these levels could be sustained or even increased, at least till the end of the century.[3] These kind of 'optimistic' estimates are based on very aggregate projections and draw on facts such as: total of assets of pension funds, life insurance funds, mutual funds and others reach as much as $14 trillion; the share of their assets invested in developing country stock markets is on average less than 5% of foreign equity holdings, and less than a quarter per cent of their total assets; an increase in the share of industrial countries' institutional funds assets going to emerging markets from, for example, a quarter per cent to half a per cent could imply large increases of investments in those markets; similarly, it is also stressed that as emerging stock market capitalisation represented 6% of world share of equity markets in 1991, (double its 1987 share, which is likely to increase, however, in coming years),

3 See, World Bank, op. cit.; WIDER, "Foreign Portfolio Investment in Emerging Equity Markets", Study Group Series No 5, Helsinki; S. Gooptu "Portfolio Investment Flows to Emerging Markets", World Bank Working Paper, WP51117, Washington D.C., March 1993.

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there is considerable scope for international equity flows to LDCs if industrial country investors hold developing country stocks in proportion to the LDC markets' share in the global total.

Finally, though we will concentrate in this paper on borrowing, it is interesting to stress that foreign direct investment (FDI) flows to developing countries are estimated[4] to have increased significantly in recent years, both in value (from $9.8 billion in 1986 to $35.9 billion in 1991) and as a share of global FDI (from 13% in 1986 to 22% in 1991).

Though there may be specific causes encouraging FDI and lending flows to LDCs, the fact that both FDI and lending flows to LDCs are increasing in parallel, and roughly concentrating on the same region, would seem to imply that similar underlying common causes (such as improved growth prospects in certain LDCs, recession in industrial countries) are also very important in explaining all these flows.

II. STRUCTURAL CHANGES IN GLOBAL PRIVATE FINANCIAL MARKETS

Deregulation and Financial Innovation

During the last ten years, the size and the structure of financial markets has undergone profound changes.

The process of structural change is very complex (largely because it is not homogeneous across countries), and is therefore difficult to understand at a global level. There are however many common features in the direction and key features of the changes, practically in all countries.

The dominant initial force explaining these changes is deregulation, which considerably enhanced the role of free market forces in determining choices open to economic agents. By the beginning of the 1980s, many of the restrictions which previously limited competition (e.g. by restrictions on lines of business, geographical operation, quantitative restrictions on credit, interest rate and price restrictions, controls on foreign exchange transactions and international capital flows) had either been removed or else been undermined by market developments. As we shall discuss further below, in this context of much greater freedom, strengthening of capital adequacy standards became the main regulatory constraint on bank portfolio choices.

As a result four trends seem to have clearly emerged. Firstly, financial markets have become increasingly globalised and integrated. Domestic markets became progressively more integrated with each other and with off-

4 World Bank, op. cit.

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shore ones. Capital flows across borders intensified and the number of institutions operating in foreign centres increased. Furthermore, the global interlocking of national financial markets has far exceeded the global interlocking of national productive structures, as the very rapid growth of international financial flows was far quicker than the growth of trade and direct investment.

Secondly, the size and the influence of markets in finance has increased markedly throughout all countries. Again here there is a contrast with the past, as till the end of the seventies the importance of financial markets was more an Anglo-Saxon peculiarity. Indeed, the fundamental changes in the regulatory and technological environment increased competitive pressures and – in a broadly favourable macroeconomic environment – led to rapid growth in financial activity and trading. The major expansion of the financial industry world-wide (as illustrated in Table 5) is reflected for example in a massive increase in turnover on all the major securities markets and in the explosion of the value of payments over the last decade; indeed, according to BIS op. cit. estimates, the ratio of annual value of financial transactions (measured as payments through the main interbank fund transfers system) to GNP in the three countries with the largest financial markets in the world grew dramatically and systematically, from less than 10% in 1970 to over 75% in 1990, for the U.S., from just over 10% in 1970 to over 110% in Japan and from around 10% in 1970 to over 40% in the United Kingdom!

Table 5 Indicators of Growth in the Financial Industry

	Share in value added [1]		
Countries	**1970**	**1979**	**1989**
U.S.A.	4.1	4.5	5.7
Japan	4.5	4.9	5.6
United Kingdom	12.5	14.8	20.0
Switzerland	4.6	5.8	10.1
Germany	3.1	4.2	5.0
France	3.3	3.5	4.7
Spain	3.5	5.7	6.5
Australia [2]	8.5	9.0	12.1

1 GNP/GDP, plus imputed bank service charge, at current prices.
2 Includes real estate and business services.

Source: Based on data in BIS 62nd Annual Report, Basle, June 1992.

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Thirdly, there has been an important trend for dissolution (where it existed, e.g. in the United Kingdom) of functional boundaries, particularly between banking and securities activities. This has led to the creation of increasingly complex institutions, which integrate both types of activities.[5] In those countries (like the United States and Japan) where barriers remain, banks are however free to combine banking and securities abroad, and are increasingly finding ways around the law in their home markets. Banks had been weakened during the last decade by a decline of underlying profitability; partly this is due – on the asset side – because they have lost some of their most profitable and safest business, as securitisation reduced the demand for bank loans from prime borrowers, as commercial paper, corporate bonds and other types of direct financing displaced bank lending; it is also due – on the liabilities side – to the fact that banks have lost part of their core interest free retail deposits, and are forced to bid for funds against each other, which has implied an increasing use of more expensive and less stable wholesale markets and a decline in the proportion of interest free deposits. More broadly as the cost of processing information fell, borrowers and lenders found it more feasible to deal with each other directly, and by-pass the banks. Partly to compensate for this decline in banks' profitability, banks, bank regulators and governments have started to break down remaining barriers between banking and securities markets, greatly enlarging banks' involvement in securities business. Though this integration of banking and securities generates economics of scope (and therefore benefits to the consumer, both due to lower costs based on joint 'production and marketing', and due to greater convenience of purchasing different financial services from a single firm) it seems likely that it will increase the risks to the financial system as a whole because securities provide additional risk-taking opportunities by aggressively managed banking institutions. This is particularly because there is empirical evidence (quoted in Dale, op cit.) that the securities business is riskier than any other financial activity, and because securities activities are less heavily regulated than banking activities. The integration of banking and securities' firms (even in countries with separate firms) could lead to conditions in which a shock coming from the securities market could spread through the banks and return (amplified) to the securities markets. The internationalisation of both markets could make such a potential crisis international. Furthermore, because the pace of product innovation in securities markets is so rapid, risks in this area are increasingly difficult to assess, both by market actors and by regulators.

5 For a detailed analysis of this trend, see R. Dale, "International Banking Deregulation, the Great Banking Experiment", Blackwell, Oxford, U.K., 1992.

Though deregulation was broadly more limited in insurance, by the early 1990s a few countries (especially in Europe) had eased restrictions on the combination of insurance with banking business.

These changes have favoured the creation of complex conglomerate structures, (often across national borders), which combine traditional banking services with various types of securities and, more recently, with the provision of insurance. In the case of 'simple' banks, also a greater proportion of their credit and liquidity exposures was incurred off-balance-sheet.

Fourthly, as hinted at above, there has been a vast expansion of available financial instruments, which was facilitated by the explosion of information technology. Many of these instruments (e.g. futures, options, swaps) are very sophisticated, and the exact level of risk they generate is as yet unclear. As the range of financial instruments grew, a higher proportion became marketable. In the U.S., even bank loans and company receivables have become marketable.

Fifthly, there was a greater institutionalisation of savings, which provided a base for the expansion and greater sophistication of the securities markets. Their push towards international diversification was important factor behind the internationalisation and integration of markets.

Evaluation of structural changes in financial markets

Deregulation was driven by the perception that constraints on financial activity were ineffective or caused important inefficiencies in the allocation of capital and operation of monetary policy. Then deregulation acquired its own momentum, as elimination of restrictions in some areas led to pressures for their relaxation elsewhere. A third reason for deregulation grew from differences in regulatory treatment.

Benefits

Deregulation has delivered important benefits.[6] Thus, both original suppliers and final users of funds are able to obtain better terms, via a richer and higher-yield range of financial assets and easier as well as cheaper access to external finance. Securitisation is seen not only to allow for lower costs, but also for longer maturities, which is crucial for the market viability of certain types of activities that only become profitable in the long-term. The abolition of foreign exchange controls, and the broader process of globalisation widened the international choice, both in terms of diversification of portfolios

6 See, for example, BIS op. cit.; also, R. O'Brien, "Global Financial Integration: The End of Geography", Pinter Publishers, U.K. 1992.

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and sources of finance. At one level, the wider range of available financial instruments allows for better distribution and management of risk. Furthermore, the fall in transaction costs has increased the liquidity of securities markets. Finally, capital can flow more freely towards higher returns.

As regards developing countries, the potential benefits of deregulation and globalisation are particularly high, as capital is relatively scarce, and thus the prospect of larger inflows via for example securities (particularly at a time when bank credit flows are far less likely to come in than in the past) and lower costs are especially attractive. It seems that certain instruments have been particularly beneficial in lowering the equity cost of capital in developing countries. Thus, international stock trading (through for example American Depository Receipts, ADRs) has proved to be a valuable mechanism for lowering LDC companies' cost of capital decline. Furthermore, the issuing of ADRs is reported [7] to not only lower costs for individual firms but also for other domestic firms via important spill-over effects.

Costs

The issue that needs to be addressed is of the costs which deregulation has brought about, and of the measures that need to be taken (both nationally and internationally) to minimise those costs. Indeed, the changes brought about by deregulation and the freeing of market forces in the financial sector, are creating new regulatory needs (such as capital adequacy requirements on financial institutions), which probably would not have existed had markets not been deregulated. It is argued in this paper that these new regulatory challenges have only partly been met, and that urgent tasks (nationally, regionally and internationally) still need to be accomplished. This is largely because on the whole the development of regulation of markets tends to lag behind the changes that deregulation brought in the structure of the financial system. Particularly if the benefits of deregulation are valued, it is important to take measures that minimise costs, especially those that could disrupt in a major way the proper functioning of those markets, and have significant negative macroeconomic effects.

The costs of financial innovation relate to greater financial instability and fragility, reflected in the form of very large fluctuations in asset prices and/or distress among financial institutions. Both asset prices and exchange rates have gone through periods of sharp fluctuations in the last decade. As the BIS

7 See, World Bank, op. cit.

op. cit. correctly points out, the main source of concern is not short-term volatility, (which if not extreme is relatively harmless), but longer-term volatility, especially when prices seem misaligned from their apparent sustainable levels, which both lead to misallocation of resources and the risk of large and disorderly changes.

One particular aspect of recent changes which may be important in contributing to explain capital market volatility is institutionalisation of savings.[8] Indeed, some U.S. commentators blamed fund managers' portfolio strategies for causing volatility at the time of the 1987 Crash. More generally, the rise of global asset allocation as a tool of fund management, and the development of markets such as stock index futures stimulated and facilitated massive growth in short-term cross-border equity flows. Though the investors wish to reduce risk by such strategies, the focus of funds on a small number of leveraged instruments often destabilises markets and leads to sharp swings in asset prices; there is also evidence that switches of resources by large fund managers affect exchange rate developments.

More generally, the greater internationalisation and integration of the financial industry meant that shocks are more easily transmitted across borders, as well as from one market to another. This is particularly well illustrated by the global nature of the stock market crashes of 1987 and 1989. Furthermore, regular performance checks against the market (as frequent as monthly in the U.S. but less in the U.K.) may induce 'herding' among funds to avoid performing worse than the median fund, again with destabilising effects on the prices of assets.

The problems of rapid switches between markets are likely to be of importance in an international context as well as in national markets. There is evidence that this is likely to have greater incidence on volatility the smaller the market (as is the case for developing countries) and the greater the role played by foreign investors in it.

This is a special source of concern for developing countries as traditionally the capital markets of LDCs show far greater volatility than those of industrialised economies. As can be seen in Table 6, the standard deviation of monthly percentage changes in share prices on the emerging markets were significantly higher than those of the U.S., U.K. or Japanese stock-markets. This was particularly true for the case of Latin American markets.

8 See, for example, E.P. Davis, "The Structure, Regulation and Performance of Pension Funds in Nine Industrial Countries", Mimeo, Bank of England, 1992; also, Howell M. and Cozzini A., "Games without Frontiers; Global Equity Markets in the 1990s", Salomon Bros, London, 1991.

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Table 6 Standard Deviation of LDC and DC Share Price Indexes (five years ending December 1989)

Market	Number of months	Standard deviation
Latin America		
Argentina	60	37
Brazil	60	21
Chile	60	8
Colombia	60	6
Mexico	60	16
Venezuela	60	12
Asia		
Korea	60	8
Taiwan	60	15
Turkey		24
IFC Regional Indexes		
Composite	60	7
Latin America	60	14
Asia	60	8
Developed Markets		
U.S. (S&P 500)	60	5
U.K. (F.T. 100)	60	6
Japan (Nikkei)	60	5

Source: IFC

A second main reflection of increased financial instability and fragility is the fact that in the 1970s and especially the 1980s there have been several episodes of financial distress among financial enterprises.

Episodes of financial distress include:

- the dollar overvaluation of the mid-1980s;
- the global stock market crash of October 1987, and the mini-crash two years later;
- property market crises (Japan, U.K.);
- extended banking crises (the secondary banking crisis in U.K., the savings and loans disaster in the U.S., the collapse of the Nordic banking system);
- bankruptcies of large individual banks (Continental Illinois), or financial conglomerates (BCCI, Maxwell);

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- crises in the inter bank market by spillovers of individual failure (Drexell Burnham Lambert, Herstatt), and
- accidents in the payment systems (Bank of New York).

It is important to emphasise that, increasingly, instability in asset prices and institutional financial distress are related, as financial intermediaries hold – or lend against – the value of assets. As discussed above, banks have, in many countries, increased their securities business; they have also increased their exposure to real estate. As a consequence, their earnings – and their financial strength – became more sensitive to price fluctuations, of both shares and real estate. Both losses in securities markets and, especially, the weakness of real estate prices have been significant in the recent problems faced by many banks.

III. INCREASES AND CHANGES IN THE NATURE OF RISKS

As a result of the changes in the structure and workings of the financial system, the nature and transmission of systemic risk changed significantly, and possibly increased.

Systemic risk is defined by the BIS as 'the risk that the collapse or insolvency of one market will be transmitted to another participant'. It is a macroeconomic phenomenon linking together different sources of financial instability, and is the unintentional outcome of externalities between decisions and conducts of individual agents under uncertainty.

A first major source of these externalities, that pose a potential for systemic risk, is the payment and settlements system; this has always been the main channel for the propagation of systemic crises, triggered usually by the inability of one or more institutions to settle their obligations. However, the explosion of the volume of financial transactions flows over the last decade has dramatically changed the scale of risks involved. These are concentrated in the inter-bank wholesale transfer systems. Banks participating in these systems incur now extremely large intraday liquidity and credit exposures, possibly larger than the exposures traditionally captured in their balance sheets and frequently less closely monitored by regulators. This increases the vulnerability of the system to a participant's default or to technical failure, heightening the risk of a domino effect. These risks have been illustrated by the international ramifications of Herstatt's bankruptcy, by the technical failure of the Bank of New York and the unwinding of Drexel.

Besides being the channel through which counterparty risk (the risk that the counterparty to a financial contract will not meet the terms of the contract) is channelled, settlement arrangements can be an independent source of systemic risk, due to computer breakdown, concentration of risk in a clearing house inadequate to sustain it in a crisis, or because incompatibility

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between timetables and legal obligations in different markets, increases the strain as turnover rises at a time of market disturbance; indeed, strains that could begin as a liquidity problem could become a solvency one.

As an OECD study [9] points out, organised settlement systems offer the opportunity to reduce or redistribute risks in a way providing better protection for market participants and for the system as a whole.

Several recent reports have made various recommendations to improve and accelerate settlement arrangements for example within and between national securities markets. These goals may take a long time to reach, due to legal problems, as well as technological and cost factors. It seems that the greatest contribution to the management of risk can potentially come from achievement of delivery versus payment, shortening of settlement periods and the construction of legally valid systems of netting.

A second major source of systemic risk is increased exposure of institutions to market risks (the risk of losses in on-and-off balance sheet positions – stemming from movements in market prices, including interest rates, exchange rates and equity values); this has happened because of the rapid development of securities and derivative markets, as well as foreign exchange contracts. Large variations in the market price of assets (e.g. shares) are a very important source and channel of transmission of potential shocks. As positions are increasingly taken across a large number of markets, problems in one part of the market can quickly be transmitted to the others. As the BIS op. cit. points out, the stock market crash of 1987 clearly illustrated how very different operating arrangements in different markets for highly substitutable instruments can have destabilising effects because they result in differing price reaction speeds and uncoordinated stoppages.

The underlying force is that the deflation of asset prices destroys financial wealth. Because banks hold a large and increasing part of tradeable assets in their portfolios (due to the liberalisation of banks' permitted range of activities and the rapid development of financial markets), or because they lent heavily to asset holders, the quality of bank assets can decline rapidly in such a situation.

The integration of market segments (and particularly that of banks and securities) thus increases the transmission of disturbances in financial markets. So do developments in information technology. The main potential channel for such transmission of disturbances is now the seizing up of funds in the wholesale markets or unwillingness for counterparties to enter into transaction with institutions whose soundness is in doubt, and not – as in the past – a generalised withdrawal of deposits.

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9 OECD, "Systemic Risks in Securities Markets", Financial Market Trends, No 49, Paris, June 1991.

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This shows that, somewhat paradoxically given increased marketability of assets, the provision of liquidity has become more important in the new financial environment. Indeed, in a situation of slump of asset prices, a key risk is that the liquidity of some market makers can be threatened, which provides a channel to spread instability between underlying and derivative markets. Because of the key importance of liquidity, banks continue to be at the heart of financial activity, even though their share of financial intermediation has fallen in several countries. Indeed, the 1987 stock market crash highlighted the need to keep open credit lines to securities and derivative market operators to precisely avoid systemic instability.

Special concerns with banks' exposure to market risks, have very recently (April 1993) led the Basle Committee on Banking Supervision to produce a consultative proposal on the Supervisory Treatment of Market Risks. This proposal suggests that specific capital charges are applied to open positions in debt and equity securities in banks' trading portfolios and in foreign exchange; these capital charges should constitute a minimum prudential standard relative to the potential for losses that might occur for a given portfolio; these would complement the capital adequacy rules approved already by the BIS referring to banks' credit risks, which began to be implemented on January 1, 1993. Secondly, the proposed capital charges for each type of instruments would be roughly equivalent in economic terms, to avoid creating artificial incentives favouring some instruments (for a copy of the Preface to the Consultative proposal of the Basle Committee, on Prudential Supervision of Market Risks, as well as Netting and Interest Rate Risk, please see Annex 1).

However, as we will discuss in the next section, regulation of banks' market risk (once implemented), though a positive development, will create problems of asymmetry with the regulation of securities' market risk, as coordination between banks' and securities' regulators (and among securities' regulators of different countries) has not yet been agreed.

Indeed, as we will develop more in the next section, it would seem that large variations between different national regulations of financial firms (and especially securities) as well as fundamentally different approaches to regulation amongst banking and securities' regulators may themselves be, at least for a time, a third source of potential increase in systemic risk. The OECD document quoted above implicitly recognises this, when it argues that: "this diversity in regulatory coverage causes international systemic concern because it encourages regulatory arbitrage, leaves some significant risk-taking activities by intermediaries outside the supervisory net, fails to deliver a comprehensive supervisory oversight of conglomerates, and complicates the task of international cooperation among supervisory authorities". All this is a particularly important source for concern, because as the Federal Reserve

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Bank of New York put it in its 1985 Annual Report: [10] "A shock that starts in one market may spread quickly along this network of linkages until it finds a weakness in some seemingly unrelated place. In fact there is a growing tendency to build financial links along regulatory fault lines where the responsibility for supervisory oversight is weak, divided or clouded".

The issue of possible systemic risks arising from differences amongst supervisors, as well as supervisory gaps in certain markets and countries, is made more serious because financial markets have become more opaque, both for supervisors and market actors, in spite of efforts carried out. This opaqueness relates to instruments, relationships across instruments and markets, as well as the organisational structure of institutions. The growing complexity of organisational structures, for example international financial conglomerates, clouds the evaluation of the soundness of an institution. As the U.K. Bingham Report shows, the trend towards opaque corporate structures – and the problems it poses to regulators – are well illustrated by the BCCI case.

An important question to ask, which seems to have been insufficiently addressed in the existing literature and by policymakers, is the extent to which the systemic risks associated with globalisation and securitisation are the same or different for flows going to developing countries. This important issue can be tackled at three different levels. One is at the level of investor protection; the second is at the level of global effects of possibly additional risks from flows to developing countries; a third level refers to the additional sources of potential macroeconomic instability generated for developing countries by these new types of flows. We will focus here on the third level, which is of particular interest to LDCs, as the first two seem far less of a source of concern, given that the share of institutions' total investments going to developing countries is at present very low, and therefore problems in LDCs would affect their total assets only marginally; furthermore, as regards global effects of potential instability in LDCs, these would not seem on the whole to be that different from other global effects of financial instability discussed above. However, this latter matter may require further study.

As regards the potential additional sources of macroeconomic instability generated for LDCs by the new type of flows, the main one would seem to relate to balance-of-payments funding risk. To the extent that securities' flows (and in particular international investment in equities) are potentially far more liquid than bank lending, then if a balance-of-payments crisis or the prospect of a major devaluation threatened in an LDC, foreign equity investors could move out very quickly. This would occur, to the extent that –

10 E. Frydl, "The challenges of financial change", Federal Reserve Bank of New York, Annual Report, 1985.

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as is the case in many LDCs, and particularly in those LDCs experiencing large portfolio flows at present – there are no or very scarce relevant foreign exchange controls (see Table 7), and to the extent that the foreign equity investors would sell their shares to nationals of the LDC, and not to other foreigners. Naturally, new foreign investment in such equities would also cease at that time. The result would be additional pressure on the balance of payments and on the exchange rate, possibly contributing to a major balance-of-payments crisis or to a large devaluation. Both would have undesirable effects on the LDC economy's levels of output and of inflation. Therefore in a pre-balance-of-payments or exchange-rate crisis situation, large international equity outflows (in relation to the domestic economy) could seriously magnify problems arising from other sources.

Table 7 Entering and Existing Emerging Markets. A summary of Investment Regulations (as of March 31, 1992)

Are listed stocks freely available to foreign investors?	Repatriation of: Income	Capital
Free Entry		
Argentina	free	free
Brazil	free	free
Colombia	free	free
Jordan	free	free
Malaysia	free	free
Pakistan	free	free
Peru	free	free
Portugal	free	free
Turkey	free	free
Relatively free entry		
Bangladesh	some restrictions	some restrictions
Chile	free	after 1 year
Costa Rica	some restrictions	some restrictions
Greece	some restrictions	some restrictions
Indonesia	some restrictions	some restrictions
Jamaica	some restrictions	some restrictions
Kenya	some restrictions	some restrictions
Mexico	free	free
Sri Lanka	some restrictions	some restrictions
Thailand	free	free
Trinidad & Tobago	relative free	relative free
Venezuela	some restrictions	some restrictions

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Special classes of shares		
China	some restrictions	some restrictions
Korea	free	free
Philippines	free	free
Zimbabwe	restricted	restricted
Authorised investors only		
India	some restrictions	some restrictions
Taiwan, China	free	free
Closed		
Nigeria	some restrictions	some restrictions

Note:
It should be noted the industries in some countries are considered strategic and are not available to foreign/non-resident investors, and that the level of foreign investment in other cases may be limited by national law or corporate policy to minority positions not to aggregate more than 49 per cent of voting stock. The summaries above refer to "new money" investment by foreign institutions; other regulations may apply to capital invested through debt conversion schemes or other sources.

Key to Access
Free entry – No significant restrictions to purchasing stocks.
Relative free entry – Some registration procedures required to ensure repatriation rights.
Special classes – Foreigners restricted to certain classes of stock, designate for foreign investors.
Authorized investors only – Only approved foreign investors may buy stocks.
Closed – closed, or access severely restricted (e.g. for non-resident nationals only).

Key to Repatriation
Income – Dividends, interest, and realised capital gains.
Capital – Initial capital invested.
Some restrictions – Typically, requires some registration with or permission of Central Bank, Ministry of Finance, or an Office of exchange Controls that may restrict the timing of exchange release.
Free – repatriation done routinely.

Source: Emerging Stocks Markets Factbook, 1992, International Finance Corporation.

Naturally, this is not just related to international equity flows, nor is it a purely LDC problem, as is clearly illustrated by the effect of private financial flows in September 1992 on several currencies in the ERM. Indeed, there have been reports that some of the investors who were involved in the 'speculative' flows that so seriously affected some of the then ERM currencies, are now "going into Latin America". [11] However, the scale of the impact could be larger for LDCs, given the smaller size of their economies and their greater fragility, and the special features of their securities markets.

11 Interview material.

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Furthermore, as discussed above, price volatility of LDC stock markets is in general higher than that for developed countries. Therefore, the impact of potentially large sales by foreign investors (or nationals with 'transnational' mentality) would be to depress particularly significantly the prices of shares. This could, via a wealth effect, contribute to a decline in aggregate demand and/or lead to other forms of financial instability. This latter would especially be the case to the extent that in the particular LDC there was strong integration of banking and securities, development of financial conglomerates, etc.

Other special features of LDC stock exchanges also increase their potential for generating negative effects in other parts of the economy. These relate, for example, in some countries to inaccurate and slow settlements procedures. As discussed above, this increases instability in the stock exchanges, that can spill over to other sectors. Furthermore, the LDC stock markets tend to suffer from a shortage of good quality, large capitalisation shares. This can result in quick overheating (that is, rapid increases in prices) when domestic and international interest is generated in these markets, due to some positive shock of expectations, and in quick 'over cooling' (that is, rapid falls in prices), due to some negative shock of expectations, as discussed above.

Though on the whole foreign direct investment flows are far more stable and long-term, it has been reported [12] that international companies often do play the 'leads and lag game' with some of their funds, for example in anticipation of a devaluation, and that this 'speculative' behaviour can be an additional, though probably a more limited, source of exchange-rate instability.

As regards bonds, held by foreign investors, two problems could arise. Firstly, if investors saw the risk of a crunch coming, there could be fears that the seniority of bonds (which has been an important factor in attracting bond finance to LDCs) could be reversed; this fear will be increased, to the extent that bonds become a high proportion of the LDC's debt. Secondly, as the bonds and their interest, are denominated in foreign exchange, if there are fears of a large devaluation, then the foreign investor would fear an increase in his credit risk. For both reasons, investors in bonds might want to sell if a balance-of-payments or exchange rate crisis was foreseen. To the extent that these bonds could be sold to nationals of the LDC (which seems more difficult than in the case of shares), then this would have a balance-of-payment funding and/or an exchange-rate effect.

Last, but certainly not least, as regards inflows to LDCs, and especially to Latin America, there is a fairly high proportion of those inflows that specifically come in for a very short period, e.g. 3 months, mainly attracted by

12 Interview material.

From: The Pursuit of Refonn: Global Finance and the Developing Countries
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interest rate differential. Naturally, these flows are highly volatile, and in the case of a threat of a balance-of-payments or exchange rate crisis, would leave very rapidly, and with destabilising effects.

Finally, it should be stressed that such major and rapid outflows of capital from LDC as have been discussed above is far more likely to occur if there is a large macroeconomic imbalance in that economy. Therefore, in the current world of globalisation and free capital flows, the importance of prudent macroeconomic policies is paramount. With prudent macro management, large, sudden outflows that are particularly destabilising are far less likely, though they cannot be completely ruled out. Indeed, the recent G-10 Dini Report acknowledges that even for the case of developed countries, "a country can experience downward pressure on its currency despite the fact that its macroeconomic policy and performance have been sound".

IV. EXISTING SUPERVISION AND REGULATION; SOME LIMITATIONS

The changing nature and possible increase of systemic risk implies a number of major challenges and issues for governments. The first one (on which we will concentrate here) is to improve prudential regulation and supervision of individual institutions, so as to curb excessive risk-taking at source.

One issue that needs clarifying is that of coverage of regulation and supervision; this should cover all those financial companies whose collapse would trigger systemic turmoil. Though there is considerable consensus (see, for example, BIS op. cit.) that supervisory coverage limited to banks may well not be enough, a number of major supervisory gaps still exist; probably the most obvious is one that allows some securities houses to carry out certain activities via unsupervised affiliates.

Above all, there are important differences in the extent to which and the form in which similar institutions are regulated in different jurisdictions, as well as different institutions are regulated both in the same and in different jurisdictions; a subject to which we will return below.

An important issue in this context is whether institutions should be supervised on a consolidated basis. The question is whether, if legal and economic separation of for example banking and securities can be achieved (which is in itself very complex), and 'firewalls' established to limit transfer of capital between them, this will be sufficient to separate the market perception of the credit standing of both institutions, and therefore isolate one unit from the other in a period of distress. As the Drexel case illustrated, funding seems to be withdrawn from institutions that are sound, due to associations in the public mind with problems arising in affiliates. Therefore, failure to

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consolidate can result in serious supervisory gaps. Though consolidation is a standard practice in banking supervision (following in particular the problems caused by Banco Ambrosiano), it is not yet generally accepted in the supervision of securities and insurance.

Consolidation of supervision between different types of activities is made difficult by conceptual difference among their regulators, based on key differences in the nature of their business. The most fundamental difference between securities and banks is that the former have a far shorter commercial time horizon than banks. Banks typically hold loans on their balance sheets until maturity, while securities' firms experience rapid asset turnover.

Because the bulk of securities firms' assets are marketable, they are subject to severe pressures in periods of market downturn (which leads therefore to market risk), and to a similar decline in the firm's net worth. Because firms need to meet losses quickly, securities regulators emphasise liquidity, treating illiquid assets consecutively and often allowing certain forms of short-term subordinated financing to be counted as capital. As the key concern is that securities' firms should be able to run themselves down in a very short period and meet their liabilities, so that their clients/counterparties will not incur losses, the key supervisory test is that of net liquid assets. Thus, a firm should have liquid assets (valued at current price) which – after allowance for possible reductions in the value of the assets before they could be sold – exceed total liabilities.

In contrast, a major proportion of bank assets are traditionally non-marketable; as a result the main risk for banks is credit risk. Differently from securities' houses, banks are not expected to respond to financial problems by going out of business, as their assets could only be sold at a heavy discount, implying losses for creditors and depositors. Therefore, the main objective of bank regulators is to sustain banks as going concerns, especially because bank failures involve risks to the financial system as a whole. Therefore bank supervisors tend to focus far less on liquidity and short-run changes in asset values, and more on the long-run viability of the bank. This explains why the regulatory definition of capital only included financing instruments of a more permanent nature (excluding for example subordinated debt from primary capital).

Regulatory differences extend also to the role of deposit insurance and lender of last resort, which are important for banks, but are on the whole unavailable for securities.

The above differences in the regulation of banks and securities' firms have for example led to difficulties for EEC policymakers in their attempts to establish an appropriate regulatory framework for the single European financial market. The EEC's Directive on the Capital Adequacy of Investment Firms and Credit Institutions (known as CAD) allows alternative

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definitions of capital for the supervisors of non-bank investment firms and for banks undertaking securities activities. As Dale op. cit. points out, these alternative definitions of capital are mainly intended to meet the policy objective of ensuring a 'level playing field', between banks and non-bank investment firms. However, there is a concern that these capital rules are not justified on prudential grounds.

In particular, though the appropriate regulatory goal defined by the EEC for bank supervisors is solvency, for securities, the EEC regulatory objective is more limited, to protect investors and counterparties without necessarily ensuring solvency, goal that can be achieved by more liberal use of subordinated debt. But, as we discussed above, given the way that securities markets developed and the Drexel episode led to a crisis of confidence in the investment firms, the EEC's objectives seem inappropriate or at least insufficient to deal with systemic risk.

Thus, the main problem with the EEC CAD directive seems to be its focus on establishing a level playing field between banks and non-bank investment firms, while failing to address the following more fundamental policy dilemma. This is that increasingly in non-banking financial markets similar systemic risks can be created as occurred previously only in narrower banking systems; if the official safety net were extended by national authorities to activities like securities, then the problem of subsidised – and thus excessive – risk taking could be extended from banks to securities.

Indeed, the EEC approach seems to accentuate these problems, as it allows banks to dilute their capital, while allowing the risk of cross-infection from securities activities to increase.

Besides the problems of new regulations in the EEC, there is the issue that the EEC and the U.S. seem to be moving in opposite directions in the key issue of risk segregation. Thus, in the EEC it is increasingly assumed that a bank would always stand behind a related securities'firm; in the U.S., the new holding company and firewall structure is designed explicitly so that a securities' firm in problem is not supported by its bank affiliate. This may imply that in Europe the lender of last resort function could be extended (directly or indirectly) to bank related securities' firms. In contrast, the U.S. scheme (which assumes that firewalls, and other mechanisms, can separate effectively risks between banking and their securities branches) would tend to restrict the official safety net only to banking.

The coexistence of these sharply opposed structures could be particularly problematic in times of global financial stress. Thus, in the EEC, the temptation could arise, for lenders to move their exposure from independent to bank-related securities, as the latter are more likely to get official support. Furthermore, in those circumstances, there would be a strong incentive for lenders to withdraw their exposure from U.S. securities in favour of

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securities' firms that are affiliates of European banks. Such large moves could accentuate financial distress in the U.S., and globally.

Indeed, it is differences in the perception of securities' regulators, (and particularly between those of the U.S. and of the rest of the countries) that have impeded a global agreement on capital requirements of securities' firms (which would have done for securities what the Basle accord has done for banking). An attempt to reach such an agreement was made, after much preparatory work, at the 1992 IOSCO (International Organisation of Securities' Commissions) Annual Conference; unfortunately, this attempt failed.[13] It should however be mentioned that IOSCO did reach some important agreements, such as the approval of principles for regulation of financial conglomerates.[14]

Perhaps equally serious is the fact that had IOSCO been able to agree on common risk measures and capital adequacy rules for securities, this would have served as a basis for a joint framework (to be elaborated by the BIS and IOSCO) for commercial banks, investment banks and securities' houses. As a result of this inability to reach agreement within IOSCO, the Basle Committee has launched its own suggestions (discussed above) to limit market and other related risks for securities activities carried out by banks, by setting capital requirements on them. If approved, this will cover an important supervisory gap, but will still leave a very large gap in the regulation of non-bank securities.

As a result, supervision and regulation globally is patchy as regards certain aspects, and very uneven. As can be clearly seen in Table 8, while securities' firms and financial conglomerates outside the EEC will not in the next few years have to adhere to any international guidelines, banks inside the EEC will have to meet three different sets of rules for measuring market risks and for capital requirements to cover those risks, (the BIS ones, the EC Directives and possibly some national ones). The issue is made more complex by the fact that Basle rules are stricter than the EC's Directive, for example as regards capital requirements on foreign exchange risk.

Indeed, as can be seen in Table 8, banks are regulated by up to three sets of regulators in an EEC country like the U.K.; they are regulated internationally by the 1988 Basle Accord and will probably be regulated by Basle on their securities activities; banks are also regulated in a country like the U.K. by its own national regulations and by the EEC capital adequacy directive. On the other hand, neither securities nor financial conglomerates outside the EEC

13 Interview material; see also, The Economist, "Capital spat", October 31st, 1992; and Financial Times, 'Tough time making a level playing field', May 4, 1993.

14 See, IOSCO, "Final Communique of the XVII Annual Conference", London, 1992.

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Table 8 Regulatory Frameworks of Financial Institutions

	International	EC [3]	USA	UK
Banks	x [1]	xx	x	xxx
Securities	–	x	x	xx
Financial Conglomerates	– [2]	x	x [4]	x

1 Includes both the 1988 Accord and the regulation of securities activities of banks, the latter proposed in 1993 and to be implemented by 1997 at the earliest.
2 There is a IOSCO proposal for principles on which to regulate financial conglomerates, but no formal regulatory agreement.
3 EC directives to be enacted by 1996.
4 Till recently, U.S. regulation of non-bank securities' houses, within major financial groups, was practically non-existent.

Source: Table prepared by the author, on the basis of interview material, BIS and IOSCO documents, Dale op. cit.

have any form of international regulation, though there are national regulations for securities; for the EEC countries, there are special EC regulations approved or in the process of approval for securities and financial conglomerates.

It would seem, that unless special efforts are made to overcome this asymmetry, it is likely to remain for quite a number of years. This relates not only to the conceptual differences between regulators discussed above (which originate largely in the diversity between different financial institutions and their differences amongst individual countries), but also due to institutional differences, for example between BIS and IOSCO. The BIS is a long established G-10 institution, which carries a lot of weight, as it provides the basis for a 'central bank of central banks'. Its members, the G-10 central banks, also are the lenders of last resort of their own banking systems. Its work on international harmonisation of supervisory standards has gone on for around 20 years. Therefore it seems to find it easier to reach agreements than IOSCO, which is a far newer institutions; though created in 1974 mainly by Latin American institutions, it became international only in 1987. Its work on harmonisation of international regulations is thus far more recent than that of the BIS. It represents bodies from 51 countries, which in itself makes it more difficult to reach agreement than in a G-10 institution. Furthermore, the

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bodies whose activities it coordinates, the securities commissions, themselves tend to be fairly young, and do not have special lender of last resort powers domestically. For these reasons it may also well continue to be more difficult to reach agreements on common regulations, and to enforce those agreements, in securities than it is in banking related activities. EEC directives, once formally approved (which tends to imply a long process), do have enforceable sanctions as they follow a legal process, unlike both the BIS and IOSCO.

Though all this is understandable, it does pose serious additional risks to the financial system originated in regulations' asymmetries.

Problems can take place even in cases where regulations are integrated, for example due to the fact that contract law exists at a national level and therefore cannot be integrated. This is particularly an issue insofar as there is growth of transactions whose settlement is at a future date.

The differences of laws amongst countries can affect for example liquidation proceedings of collapsed financial institutions, to favour one group of national creditors against the rest.[15] It therefore not only creates inequalities internationally, but also imposes additional pressures on settling situations of financial failure. The promotion of international treaties, e.g. via the UN, the GATT or other bodies, though complex to achieve, would need to play an important role to help overcome these types of problems internationally, whereas in the context of the EEC these problems would decrease as integration progresses.

Besides the general issues relating to supervision and regulation in the new financial environment, there may be specific issues posed by the new types of risk generated by the impact of these new trends specifically related to LDCs. Though for example, national securities' regulators do have special treatment for firms investing in LDCs (which in the U.K. case discriminates somewhat between different types of LDCs, mainly related to the quality of regulations of the countries' stock exchange),[16] the focus on LDCs seems somewhat limited; it does, for example, not take account of macroeconomic developments in those countries even in the context of its possible impact on investor protection.

On the broader issue of the effects of financial flows on macroeconomic performance of countries (and specifically LDCs), this is explicitly not a matter of concern to any of the regulatory bodies, unless it affects the potential solvency of the financial institutions which they regulate.[17] This

15 Interview material.

16 Interview material.

17 Interview material.

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poses the need for other international institutions (e.g. the IMF), possibly for regional bodies, and for the national recipient governments to closely monitor the impact of such flows on current and future macroeconomic trends in the LDCs, and possibly to define specific regulations to influence the level and composition of such flows.

V. CONCLUSIONS AND POLICY RECOMMENDATIONS

There is a growing consensus that global financial deregulation and liberalisation, though having many positive effects, have also resulted both in greater risks for the global financial system and for individual investors. As R. Breuer, Member of the Board of Managing Directors, Deutsche Bank succinctly put it: "This leads to a need for re-regulation and harmonisation of supervisory legislation".[18] This does on the whole clearly not mean a return to the types of regulations that existed in the 1970s, but to types of regulations appropriate for the needs of the new financial system of the 1990s, resulting largely from deregulation.

Though it may seem somewhat paradoxical, the more free-enterprise-oriented a country is, the greater the role of official supervision of financial institutions will be in such a country. This is due to the fact that in a truly market-oriented economy, the danger of business failures will be high, leading to greater risk to the balance sheets of the financial institutions lending to the business sector. Especially if governments and central banks wish not to bail out financial institutions, then deregulation needs to be supported by close and well coordinated supervision of financial institutions.

From our above analysis, we can see that to achieve close and coordinated supervision of financial institutions globally a number of important tasks need to be accomplished. These pose an important and difficult challenge to governments and especially to regulators.

Firstly, the issue of appropriate and coordinated supervision of securities needs to be dealt with far quicker than in recent years. Though the recent Basle consultative proposal makes a valuable effort in dealing with the complex issues of regulating capital adequacy for banks' securities activities, no equivalent basis exists yet for non-banks' securities. This is an important regulatory gap that needs to be filled fairly urgently. As discussed briefly above, this will need, as a pre-condition, to overcome the differences in regulatory approach to risks in securities between the U.S. and other countries, and in particular the EEC.

18 R. Breuer, "Financial Integration – The End of Geography", IOSCO XVII Annual Conference, London, October 1992.

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Furthermore, to achieve a more closely integrated system of supervision of internationally active intermediaries in securities markets, this would probably require securities regulators to develop their equivalent of the Basle Concordat for banking supervisors, defining the responsibilities of a lead regulator in the home country in relation to host countries.

Secondly, more generally, a serious effort needs to be made to extend regulatory coverage to financial institutions that are now effectively unregulated, such as financial conglomerates. This requires closer coordination between banking and securities' supervisors. If this is not done, competitive realities will continue to lead to a shift of business away from more regulated to less regulated entities, increasing the risks to the safety and soundness of the financial system.

Thirdly, though agreements on capital requirements for banks – and hopefully in the near future for their securitised activities – in the context of Basle provide a key regulatory input, there also needs to be a large effort to reach agreements on standards, e.g. accounting standards and disclosure standards. These agreements need to be reached first globally within each financial industry's regulators (e.g. banking, securities and insurance) and then agreements to coordinate such standards need to be met. Particular emphasis must be placed on integrating LDC representatives into these efforts, as their standards may often be lower or different from those of the developed countries.

Fourthly, additional work needs to be done to make improvements in specific aspects, such as the organisation of settlements systems for securities, so as to avoid them acting as an independent source of systemic risk. Organised settlement systems offer the opportunity to reduce or redistribute risks in a way that provides better protection both for participants in markets and the system as a whole. Among the measures necessary to improve and accelerate settlements arrangements within and between national securities markets are: the shortening of settlements periods, the establishment of links between settlement arrangements in home and host countries and, especially, the achievement of simultaneous good delivery of securities against payment for them.

Fifth, as discussed above, there may be an increasing need to achieve greater global integration of contract law, so that contracts can be challenged internationally, and regulators can carry out liquidation proceedings that are internationally equitable. Such legal integration would both facilitate further global financial integration and aid the task of regulators in effectively and equitably enforcing their regulations. Naturally, this task poses difficult issues relating to the promotion of international treaties.

Sixth, the issues raised above – and others raised by globalisation and increased complexity of finance – seem to require creation of a strong and

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ongoing institutional capacity, at the international level. At a minimum, this would require in particular a substantial strengthening of IOSCO and a closer integration of all countries in to the Basle Accord. A more ambitious approach – both far more difficult to implement and far more satisfactory – would be to create a global board of regulators,[19] with central banks and other regulatory representatives, and possibly with members drawn from the private sector. Such a body could set mutually acceptable minimum capital requirements for all major financial institutions, establish uniform trading, reporting and disclosure standards and monitor the performance of markets and financial institutions.

One of the virtues of such an approach is that it would increasingly achieve a truly global perspective on regulation, integrating both different national and functional perspectives; at present such global perspectives are difficult to achieve as regulators respond to their constituencies and their conceptual frameworks (both at a national level and at a functional level). This is clearly a more long-term task.

Besides the above described initiatives at a regulatory level, two initiatives can be suggested, one that specifically focuses on LDCs and the second, on a proposal for an international tax. There is a specific need to fairly urgently monitor precisely the scale and composition of capital inflows into developing countries. Due to the rapid pace of innovation, and to other factors, this is no easy task. Important efforts are being carried out in this area by the World Bank and the IMF. Beyond monitoring, there seems to be a need to assess at least the present and likely future macroeconomic impact of such flows on the LDCs. There may be fears that the scale and/or composition of the flows is having important undesirable effects, for example on overvaluing exchange rates via a 'financial Dutch disease phenomenon' which will discourage export growth; or there may be related fears that a dramatic reverse of large flows could have negative future effects, on output or inflation, as occurred in the debt crises of the 1980s (though the mechanisms would be slightly different). In such situations, there may be a case for measures to be taken to discourage excessive inflows, especially of certain types of flows (e.g. shorter-term ones).

An important issue is – institutionally – who should take the initiative. Clearly the first level is that of national LDC governments; thus, the Chilean, Mexican and Brazilian governments have taken such measures in recent years. Secondly, regional institutions (e.g. ECLAC in Latin America) and/or regional development banks (e.g. IDB) can take an interest. Thirdly, global institutions, such as particularly the IMF and the World Bank need to take an interest, and exert influence, especially to the extent that insufficient action

19 H. Kaufmann, at the 1992 IOSCO Conference, suggested the creation of such a body, and called it 'Board of Overseers of Major International Institutions and Markets'.

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takes place at the national level (the recent dispute between the Argentine government and the IMF on the need for reserve requirements on capital inflows provides a good example).

Such actions need above all to be guided by the principle that the capital inflows to LDCs should contribute to countries' long-term growth and development on a sustained basis, and that future debt or major foreign exchange crises need to be avoided. The last LDC debt crisis is such a recent phenomenon, that we can all remember the 'sins of omission' by different key actors and extract relevant lessons for the management of the new type of private flows of the nineties, so that their long-term effect is more beneficial and sustained.

Finally, a measure that may deserve attention is Tobin's proposal to levy an international uniform tax on spot transactions in foreign exchange.[20] Tobin's proposal is for a 1/4 per cent tax on currency transactions. The aim would be to slow down speculative, short-term capital flows movements (which would be more affected as by definition they cross borders often, and would be taxed every time), while having only a marginal effect on long-term flows. This would somewhat increase the autonomy of national authorities for monetary and macroeconomic policy, with a bit more independence from the effects of international money markets. Such an autonomy would be particularly valuable for LDCs, to the extent that their economies adapt less easily to external shocks and because their thinner financial markets are more vulnerable to the impact of external capital inflows and outflows. The proposal would be particularly attractive to LDCs if the proceeds of it were to go, as Tobin suggested, to the World Bank.

This proposal is different from the other seven listed above, in that it may seem more radical. However, there is a widespread feeling, even in private circles, that financial liberalisation may have proceeded too far or at least too fast, and that financial liberalisation carried to the extreme may even risk damaging the far more important trade liberalisation, whose benefits are far more universally recognised. Furthermore, a new tax would be attractive to fiscally constrained governments.

Therefore, a small tax on financial flows – which particularly discourages short-term flows – could be a welcome development. It could be introduced on a temporary basis for a fixed period, e.g. 5 years. This would be consistent with the fairly widespread perception that financial fragility and systemic risk are particularly high in the current stage of 'transition' from regulated to deregulated financial markets.

The tax would have an additional advantage. It could greatly facilitate monitoring of international financial flows, by providing centralised data

20 J. Tobin, "Tax the speculators", Financial Times, December 22, 1992.

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basis on such flows. This could be particularly valuable for innovative flows and flows going to LDCs, where large information gaps exist.

Doubtless technical problems would need to be overcome. An institution like the IMF would be very competent to deal with them. More seriously, probably, would be the opposition of certain parts of the financial community, which would lobby against such a proposal. However, the attractiveness of the idea, and an apparent increase in support for that type of initiative, could lead to such an innovative measure to be taken globally.

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Annex 1

The Prudential Supervision of Netting, Market Risks and Interest Rate Risk

Preface to Consultative proposal by the Basle Committee on Banking Supervision Basle, April 1993

1. The Basle Committee on Banking Supervision[1] under the Chairmanship of Mr. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, is today issuing for comment a package of supervisory proposals dealing with netting and market risks, together with an interim approach for the measurement of interest rate risk. Although each of these papers represents a discrete proposal, there are linkages in the implications they would have for banks' adherence to supervisory standards and requirements. The Committee has therefore decided to issue all three papers simultaneously.
2. The issue of the papers has been undertaken with the agreement of the central bank Governors of the G-10 countries. Comments on the proposals are invited by end-December 1993.
3. The principal objective of the consultative process is to solicit the insights and judgement of private sector institutions and practitioners on the substance of the proposals, particularly in so far as they apply to dual objectives of meaningful prudential standards and further movement towards regulatory convergence and competitive equality. The Committee recognises that some institutions may face problems in the application of the proposals. One of the objectives of the consultative procedure is to identify the nature and cause of these difficulties and any resulting compliance problems.
4. The package contains proposals for certain modifications to the Basle Capital Accord[2] of July 1988 which will affect institutions' capital requirements. The market risk proposals could result in a higher or lower

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1 The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basle.

2 In July 1988 the Basle Committee established a common measurement system and a minimum standard for the capital adequacy of international banks in the Group of Ten countries. These arrangements, commonly referred to as the Basle Accord, came into full force at the end of 1992 and have been adopted by numerous other countries.

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aggregate capital requirement, depending on the risk profile of the individual institution. This is because some of the requirements will substitute for existing credit risk requirements. However, banks may have reduced overall capital charges under the netting proposal to the extent that they have legally valid netting arrangements governing their trading in certain financial instruments. The proposals for interest rate risk do not involve capital charges because they address only the measurement of interest rate risk.

I. NETTING

5. The proposal on netting defines the precise conditions under which banks would be permitted to net the credit risks arising from trading in certain financial instruments under the Basle Capital Accord of July 1988. The conditions laid down extend and define more clearly the present netting arrangements in the Accord (these conditions are consistent with the principles laid down in the Lamfalussy report by the Committee on Interbank Netting Schemes published in November 1990). The paper contains a proposed text to amend the Accord in order to recognise certain bilateral netting arrangements. The paper also indicates the Committee's preliminary thinking on the conditions under which multilateral netting might be recognised for capital measurement purposes at some future date.
6. Following the consultation period, it is expected that the proposals for bilateral netting would be implemented relatively rapidly.

II. MARKET RISKS

7. The work by the Basle Committee on market risks has been in progress for several years, having started in earnest when the Basle Capital Accord was finalised in July 1988. It was clear at that time that banks' trading activities were expanding rapidly, particularly in the derivative markets, and that the Accord's focus on credit risk would need to be widened, in due course, to encompass market risks. The Committee is now proposing that specific capital charges should be applied to open positions (including derivative positions) in debt and equity securities in banks' trading portfolios and in foreign exchange. Securities held in banks' investment accounts would continue to be covered by the counterparty credit risk requirements of the present Accord and would also become subject to the measurement of interest rate risk described in the third paper in the package.
8. Parallel work in two other fora have interacted with and influenced the development of capital requirements for banks' market risks. One has been

the European Community's attempts to establish a single market in banking and finance. Because of the need perceived in Europe to create a level playing-field between banks and non-banks operating in the same securities markets, the Community has enacted a Capital Adequacy Directive which applies to both banks and securities firms. The coverage of this Directive is rather wider than the Basle Committee's present proposals but in general the methodology and much of the detail in the Capital Adequacy Directive is similar to the approach favoured by the Basle Committee since the outset of its work. Where there are significant differences, notably in the treatment of foreign exchange risk and position risk in equities, the Basle Committee favours a stricter prudential standard for banks. Banks are invited to comment on any problems that may arise from the need to comply with two regimes. The Committee is resolved to collaborate with its colleagues in Brussels with a view to achieving closer convergence.

9. The second forum in which parallel work has been in progress is the Technical Committee of the International Organisations of Securities Commissions, which began to discuss the possibility of common minimum standards for securities firms at that Committee's first meeting in July 1987. The Basle Committee was naturally interested in this project and joint work was undertaken with a view to developing common minimum charges for banks' and securities firms' positions in traded debt securities and equities and related derivative instruments. Unfortunately, these discussions have not led to a successful result because IOSCO has been unable to reach agreement within its own group.

10. While regretting the inability of IOSCO to associate itself with these specific proposals, the Basle Committee has decided to proceed with publication of the proposals because of the urgency of obtaining systematic input from banking institutions and practitioners. The banking industry is the focus of the consultation process. However, in anticipation of broader-based convergence, the overall approach has been designed with a view to its ultimate application to a wider spectrum of institutions.

III. INTEREST RATE RISK

11. The market risk proposals to apply capital requirements to debt securities in banks' trading portfolios do not address the overall interest rate risks run by banks, i.e. the risk that a change in interest rates might adversely affect a bank's financial condition through its effect on all interest-related assets, liabilities and off-balance-sheet items, including the securities which are not held in the trading account. Interest rate risk for a bank is a much wider issue and raises many difficult measurement problems. At the same time, it is a

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significant risk which banks and their supervisors need to monitor carefully. Analytical work has been going on for a number of years to measure interest rate risk and the progress of this work is described in the third paper in the package.

12. This paper clearly indicates that it is the intention of the Basle Committee to develop a measurement system rather than an explicit capital charge for interest rate risk. Recognising that a certain degree of interest rate mismatching is a normal feature of the business of banking, the Committee holds the view that the existing capital requirements can be regarded as providing adequate protection against interest rate risk exposure in most situations. The measurement system is designed to identify institutions that may be incurring extraordinarily large amounts of interest rate risk. Within that context, it would be left to national authorities to determine what if anything might be done. The range of responses by national authorities might include an explicit capital charge on a case-by-case basis, but the situation could also be dealt with by a number of other supervisory remedies.

13. Following consultation on this paper, it is the intention of the Committee to seek to establish a common reporting framework for interest rate risk as a basis for developing, over time, a common approach to the measurement of the risk.

14. Member of the Basle Committee are issuing these papers in their respective countries. The consultative process will be handled at national level in the first instance and the Committee will coordinate the comments and responses made to its members individually.

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Comment on "Globalisation of Financial Markets," by Stephany Griffith-Jones

Mohamed A. El-Erian [1]

In this well written and comprehensive paper, Dr. Griffith-Jones provides a timely discussion of a range of supervisory and regulatory issues affecting international financial markets. Specifically, the paper (i) reviews recent trends in international capital market flows; (ii) analyses structural changes in markets, with emphasis on deregulation and financial innovation; (iii) assesses their impact on the magnitude and nature of systemic risk; and, (iv) evaluates supervisory and regulatory issues.

The paper's broad coverage poses a difficult challenge for discussants – which aspects to cover in the limited time available. The approach that I would propose to adopt focuses on selected aspects of the analysis. Thus following a brief summary of the main points of the paper and some general comments, I intend to provide some thoughts aimed at deepening the analysis of developing country issues. This reflects three factors. First, while the paper recognises their importance, it devotes relatively less attention to them. Second, there are important linkages to the other topics that are being discussed in this conference (including ways to improve developing country access to international liquidity and, more generally, the financing of development). Third, I am able to draw on work undertaken in the IMF in the context of (i) policy discussions with member countries; (ii) regular analysis of issues in the areas of surveillance, international capital markets, and private market financing for developing countries; and (iii) special studies including on such issues as recent surges of capital flows to developing countries.

Main findings

The paper's main findings may be classified into three groups; quantitative aspects, structural changes, and policy recommendations.

In its quantitative assessment of recent developments, the paper points to the large increase in borrowing on international capital markets in 1991-92 led by securities issues (in absolute terms) and non-underwritten facilities

1 The views expressed are those of the author and do not necessarily reflect those of the International Monetary Fund.

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(with the highest growth rate). It notes that the developing country share in total borrowing has risen compared with the 1980s but that flows remain concentrated in a few countries. Finally, based on measures of the current weight of developing country exposure in the portfolios of institutional investors in industrial countries, it suggests that there is considerable scope for growth in flows to developing countries.

Underlying these quantitative aspects is a process characterised, inter alia by: greater globalisation and integration of financial markets; an erosion of functional boundaries, as reflected in increasingly complex institutions and a broader range of instruments; and greater institutionalisation of savings. The paper argues that this process has been associated with an increase in systemic risk which has not been fully matched by strengthening of the regulatory and supervisory regime. Accordingly, the paper conjectures greater financial instability and fragility as reflected in "very large fluctuations in asset prices and/or distress among financial institutions". Moreover, it notes that developing country markets have shown far greater volatility than those in industrial countries and argues that the new capital flows provide an additional source of potential macroeconomic instability.

The paper's policy recommendations include enhanced regulatory and supervisory coverage of financial conglomerates; greater harmonisation of accounting and disclosure standards; improved organisation of settlement systems for securities; establishing a level playing field between securities and banking entities; and strengthening the institutional structure at the international level.

Some general comments

The paper provides a useful overview of regulatory and supervisory issues as they affect financial markets. However, the analysis does leave the reader with several unfinished items. Five may be mentioned at this stage with a view to identifying areas where further research is warranted under the general theme and direction of this conference and FONDAD's activities in general.

First, to what extent can linkages be drawn between the analysis of the different sections of the paper – particularly between the structural aspects covered in Section III and the policy discussion of Section IV. Among the factors that would be worth addressing more explicitly is the design of policy responses which provide for the efficiency gains associated with structural changes while avoiding "over-regulation" that unduly increases transactions' costs of financial operations.

Second, the paper's discussion of systemic risk could be usefully expanded to go beyond a simple identification of the potential sources of such risk. Thus, and following up on a point made by Professor Kenen

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during the morning session, there is a need for greater differentiation between the impact of (i) deregulation, (ii) inadequate macroeconomic policy harmonisation, and (iii) market failures. [2]

Third, the bulk of the policy recommendations put forward in the paper cover areas where international deliberations are, in fact, already on-going in various fora (Basle Committee, IOSCO, EC, etc.). Perhaps something more could have been said in the paper about the approach being taken in these deliberations and the scope for progress – particularly in harmonising the implementation of a comprehensive regulatory and supervisory framework which promotes efficiency gains while minimising the opportunities for disruptive arbitrage among national jurisdictions.

Fourth, I would suggest that there is a need for the paper to be more explicit as to what are the objectives of strengthening the regulatory and supervisory regime. There are hints in some parts of the paper that an objective is to sustain individual firms. I would argue that the aim is to preserve the integrity of the financial system, which may be best safeguarded in some circumstances by allowing individual firms to fail. Indeed, the "too big to fail" doctrine must be weighed carefully against concerns for avoiding moral hazard and sustaining market discipline. [3]

Finally, in discussing the prospects for effective multilateral harmonisation of regulation and supervision, it is important to recognise the need to go beyond the technical elements. At the heart of an effective system is a willingness for national authorities to yield a degree of sovereignty.[4] This can take the form of either going from discretion to rule-based systems, or transferring policy making to an international level. Here, and in addition to socio-political factors, we are immediately confronted with a range of enforcement problems.

I believe that these are important issues that need to be explored in greater depth in order to address this session's central question – i.e. "How can monetary authorities improve their supervision" with a view to encouraging efficient international mobilisation and allocation of financial resources.

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2 A related discussion of these issues may be found in Goldstein, M. et al. "International Capital Markets", Part I, IMF, 1993.

3 See, for example, the discussion of key issues in official safety nets contained in Leipold, A. et al. "International Capital Markets – Development and Prospects", IMF, 1991.

4 For a discussion of related issues see Guitian, M., "Rules and Discretion in International Economic Policy", Occasional Paper No. 97, IMF, 1992.

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Developing country issues

Having provided some general thoughts on the paper, allow me to comment more specifically on developing country issues. In this context, there is a strong need for a systemic analysis of the regulatory adaptations required if developing countries are to be effective participants in, and benefit in a sustained manner from, the process of globalisation and integration of financial markets. Such an analysis would cover two groups of issues: (i) adaptations in developing countries, including aspects of financial sector reform, strengthening of prudential regulations in line with international standards, improved accounting and disclosure mechanisms, better circuit breakers, etc.; and (ii) adaptations in industrial countries including actions to remove possible impediments to market access by developing countries and specific regulatory issues (capital adequacy risk weights, bond risk rating cut-offs, provisioning baskets, etc.) [5]

It is also important to gain a comprehensive understanding of the nature of different flows to developing countries in order to assess their actual and potential micro- and macroeconomic effects and to craft the appropriate policy response. Generalisations of the type included in the paper, while tempting, may be misleading when applied to specific cases. Let me illustrate by referring to the surge in capital inflows that has been experienced by some developing countries in Latin America, Asia, and the Middle East.[6] An understanding of the factors behind the surge is critical to the design of policy responses which seek to balance the accommodation of potentially higher investment and growth afforded by the inflows with the containment of their potential destabilising effects. Theoretical and case study work in this area undertaken at the Fund has pointed to the importance of (i) "push factors" associated with the stance of policies in industrial countries (particularly monetary policy) and "bandwagon effects" in financial markets; and (ii) "pull factors" ranging from improvements in country productivity and competitiveness (and therefore expected return to investments) to a macroeconomic policy mix placing a relative importance of such factors (admittedly difficult to determine in practice), as well as the composition of flows, influences judgement about the sustainability and impact of the capital inflows and, accordingly, the balance in policy response between improving

5 See, for example, Collyns C. et al., "Private Market Financing for Developing Countries", IMF, 1992.

6 A more detailed discussion may be found in Calvo, G.A. et al., "Capital Inflows and Real Exchange Rate Appreciation in Latin America: The Role of External factors", IMF Staff papers, 1993; and, Schadler S. et al., "Recent experiences with Surges in Capital Inflows", mimeo, IMF 1993.

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the absorptive capacity of the economy and containing the disruptive elements.

My final comment on developing country issues relates to the proposition in the paper that the potential for macroeconomic instability has increased in developing countries as a result of international financial market integration. It must be recognised that emerging markets in their initial stages are likely to be volatile and that the broadening of the investment base could reduce this volatility over time. More importantly, it seems to me that there is greater ambiguity here than the one-to-one mapping between financial integration and macroeconomic instability that is suggested in the paper. Financial market integration increases the channels for savings – both domestic and foreign – to be channelled into productive investment in developing countries. It also facilitates the operation of price signals in lieu of what has repeatedly proved to be disruptive market clearing through quantitative rationing. Indeed, and as illustrated by developments in some Latin American markets in the past year or so, there is now greater scope for price changes to signal the need for policy adjustments in the face of emerging problems before the situation evolves to the point of a cutting off of market access. These factors can in fact serve to reduce macroeconomic instability (including through credibility, signalling, and early market discipline mechanisms) in the context of the sustained implementation of sound economic and financial policies.

Concluding remarks

In conclusion, allow me to than Dr. Griffith-Jones for providing us with a comprehensive coverage of regulatory and supervisory issues in international financial markets. The paper's analysis provides a good basis for discussion of aspects that affect the mobilisation and allocation of financial resources.

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Comment on "Globalisation of Financial Markets," by Stephany Griffith-Jones

Vítor Gaspar

The paper presented by Stephany Griffith-Jones covers a very broad set of issues, making it difficult to do the argument full justice in a short comment. I will therefore concentrate on two issues: (i) implications for regulation and supervision of the increased international integration of financial markets; (ii) implications for the LDCs.

Regulation and supervision in global financial markets

One of the main messages of the paper is that the emergence of global financial markets and the trends towards financial liberalisation and deregulation not only increased competition and reduced profit margins and economic rents – thereby increasing efficiency and, "all other things being constant", ensuring better terms for both borrowers and lenders – but also increased the risks for the stability of the financial system. These risks constitute a major challenge to the ability of regulators both at the national level and at the level of international coordination.

One message of the paper is that it is crucial "to achieve close coordination in the supervision of financial institutions". This is certainly a message that has to be taken seriously. Actually it seems that it is already being taken seriously at different international forums. But assuming that the current efforts to strengthen international cooperation in regulating and supervising banks prove successful, then one could perhaps avoid the conclusion in the paper that "financial liberalisation has proceeded too far or at least too fast". As stated in the paper, the efforts at the international level ought to seek to achieve, among other things, a levelling of the field of play in the regulation sphere through a general improvement of the standards of transparency and disclosure requirements, through the improvement of settlement systems' safety features, and through the consolidated supervision of financial conglomerates.

Let us consider for a moment the particular role of banks. Banks perform the important functions of delegated monitoring of investment opportunities and the transformation of non-liquid assets into liquid liabilities.

The function of delegated monitoring is crucial to the understanding of economies of scale and scope, which is in banking derived from the activities

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of information-gathering in the form of screening and monitoring. To an important extent, imperfections – that is, deviations from the perfect competition benchmark – in the functioning of financial markets derive from uncertainty and asymmetrical information. It is therefore crucial to provide sound incentives in order to deal adequately with moral hazard or adverse selection problems. One possibility would be to increase the use of price and cost signals to avoid excessive risk-taking. This approach could be used, for example, in the field of Deposit Insurance Schemes.

In other words, it seems to me that the conclusion should be that financial liberalisation increases the role for official supervision of financial institutions; not necessarily that we should tamper with market mechanisms. Therefore I would be extremely cautious about accepting Tobin's proposal for a tax on foreign exchange transactions, on the grounds that any transactions tax is a tax on the functioning of markets, and therefore will (probably) induce efficiency losses.

Implications of global financial markets for LDCs

The 1980s witnessed the emergence of a true global financial market. Nevertheless, the enormous increase in activity registered in the international financial markets was not directed to developing countries. Despite the rapid growth registered in the period 1987-1992, borrowing by developing countries in international capital markets was lower in 1992 than the levels attained in 1981. Of course, the trend during the 80s was marked by the so-called debt crisis. Further, as stressed in the paper, recent trends differ very much from country to country. It is extremely difficult to speak of developing countries as a bloc.

The importance of international financial flows as an engine for economic growth in LDCs is probably quite limited. According to an accounting exercise first presented by Robert Solow[1] the direct impact of a capital inflow of, say, 5 per cent of GDP (which is a relatively large figure) would yield a maximal 0.55 per cent growth in GDP.

One may also follow Krugman[2] and distinguish between:

- *capital flows involving long-term transfers of real resources*, the benefits from which include the allocation of savings to the best investment

1 Robert Solow, "Technical Change and the Aggregate Production Function", In: Review of Economics and Statistics, 39, (1957), pp. 312-20. The same argument is made by Paul Krugman in "International Finance and Economic Development", In: Alberto Giovannini (ed), "Finance and Development: issues and experience", Cambridge University Press, 1993.

2 "Economic Integration in Europe: Some conceptual Issues", In: Tommaso Padoa-Schioppa, "Efficiency, Stability and Equity", Oxford University Press, 1987.

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opportunities available internationally, and the possibility of income smoothing in response to national economic shocks; and,

- *bilateral capital flows*, allowing for portfolio diversification, economies of scale and scope associated with financial intermediation and information networks, and for increased competition. Bilateral capital flows make it possible to have important effects on market efficiency in the absence of sizeable net resource transfers.

Therefore, openness to international financial flows should increase competition and efficiency in the domestic financial system, constituting an important element in the transition to a market-based resource allocation mechanism.

Despite the limited direct impact of capital flows involving a net transfer of resources, it is possible, as stated in the paper, that private financial flows reflect better growth prospects. In this sense, the recent trends in the financing of developing countries could be a consequence of policy reforms instituted in the second half of the 1980s and early 1990s, including greater openness to trade and fiscal consolidation. Private capital inflows into developing countries could be regarded as an important signal of sustained economic regime change, which could have a by no means negligible impact on growth prospects.

The paper seems to argue that greater openness to international capital flows increases the volatility of LDCs' capital markets. To my mind the impact is ambiguous. The volatility of asset prices in LDCs' markets reflect this narrowness. Therefore the broadening of participation and the deepening of the market that is associated with greater openness should help to stabilise the market. Nevertheless, as the paper points out, there are risks. But these risks would, in turn, improve the benefits from:

- adequate mechanisms for enforcing property rights and financial contracts;
- adequate regulatory, supervision and settlements systems;
- stable and consistent macroeconomic policies.

If this is the case, then greater openness to international financial markets would improve the likelihood of sound economic policies which are necessary conditions for sustainable growth.

The fact that international financial market integration decreases the room for autonomous economic policies and therefore limits the scope for discretion may prove to be a very important benefit. In this sense the absence of autonomy may be a blessing.

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Floor Discussion of the Griffith-Jones Paper

The Tobin Tax

Though the Tobin tax proposal was only one of the many recommendations in Stephany Griffith-Jones' paper, it attracted the most attention. Many thought it would not help at all; only a few felt that it had some merit.

Jean-Jacques Rey succinctly formulated the doubts he and other central bankers had about the Tobin tax: "It seems to me that it will work so indiscriminately that it will be difficult to make sure that it actually achieves the purpose for which it is instituted." Griffith-Jones' acknowledgement that technical problems would have be overcome before it could be implemented was "an understatement", he said. "I can think of many ways in which tax payments would quickly evaporate when such a tax would be enforced, and I am sure that André Szász and I can imagine various ways to transact in Benelux to avoid it." Proposals like the Tobin tax, in his view, seemed to be inspired by the idea that if one can't make sure the wheel moves in the right direction, one puts some sand in the wheel. "I am not sure that is really advisable," he noted.

John Williamson observed that though such a tax would probably substantially reduce the day-to-day trading on the money markets, it would hardly affect trading once a speculative drive against a currency had started. "When there is only a one-way option, a 25 basis point option the other way is not going to influence anybody," he explained. Moreover, the Tobin tax would not only penalise the 'bad guys', the speculators, but also the 'good guys'. "If exchange rates have become misaligned, you are taxing the people who want to support the currency just as much as those who are wanting to get out," Williamson said.

Ariel Buira saw another problem with the Tobin tax. He was afraid that it would affect the trading of developing countries. "Since most of the trade operations of LDCs are recorded and paid in foreign currencies, you may unwittingly also be imposing a tax on trade," he said.

Philippe Moutot wondered whether the Tobin tax would not absolve the national authorities from the necessary coordination, while he believed that such coordination might be a much better way to address the problem of speculative currency transactions than the Tobin tax. One should bear in mind that speculation is not only provoked by deficiencies or efficiencies of markets but also by inefficiencies and a lack of coordination of monetary

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authorities, he warned. "We should not overlook the fact that markets are very dependent on expectations of the future, and expectations of the future, in turn, are very dependent not only on the fundamentals of each country but on the coordination between the national authorities as well."

Interestingly enough, central banker Wolfgang Rieke expressed some sympathy for the idea behind the Tobin tax, though he immediately added that he would not support it as long as he had not heard strong arguments in its favour.

"I cannot help being impressed by the enormous number of foreign exchange transactions relative to real foreign transactions in the world. Foreign exchange trading is something that takes place to a large extent unrelated to anything that has to do with real trade. The costs of doing this business have come down enormously: telephone costs are now only a fraction of what they used to be, and so forth. The people who are engaged in this business, the so-called '20-years old', live on turnover. So there will also always be a temptation to create news which then creates turnover. All this could possibly be slowed down somewhat by a tax as proposed by Tobin. But a tax of 1/4 per cent would certainly not be a factor that would hinder these people from going on with their operations," Rieke said.

Peter Kenen stressed that a Tobin tax regime could only work if it were globally comprehensive. "I can just see a BCCI operating out of the Channel Islands and conducting your foreign exchange business for you very profitably and not paying the tax," he said.

John Langmore was one of the few who came down strongly in favour of the Tobin tax. He thought it would be a good instrument for influencing the 'herd instinct' in financial markets. "It will reduce the extreme of overshooting, and that is very valuable," he said. Since many other transactions are taxed in some form or other, the absence of taxing on spot transactions in foreign exchange acts as a strong incentive for speculators to operate in this market rather than in others, Langmore argued. He believed that the costs of the Tobin tax for longer-term investors would be negligible and that such a tax would therefore not interfere with genuine investments.

Better regulation and coordination

Percy Mistry stressed that the issue of the regulation of securities and banking, both domestically and globally, is an area which requires much more attention now, "especially where developing countries are concerned." As an example "of a colossal regulatory failure" he referred to the stock market collapse in India in April 1992, which created a loss of almost fifty billion rupees on the banking system.

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John Williamson, on the other hand, referring to the 1987 stock market collapse in New York, argued that crises in securities markets were not all that bad.

"If one looks back to 1987, to what has been called Black Monday but in my view could better be named Golden Monday, one just sees how wonderfully well the market worked, because the stock market had got itself overvalued and then very quickly corrected itself before it had time to create real damage to the economy. The same thing is true in equity markets. Why should we worry when they go up and down?" Williamson asked provocatively.

Ariel Buira did not think there is a greater risk of instability in securities markets today than there was some years ago. On the question of the possibility that investors might move out suddenly, he suggested distinguishing between three types of flows:

* *direct foreign investment*, in which investors are committed to bring in machinery and cannot move out quickly even if they fear there is going to be an exchange-rate crisis;
* *equities*, where, if investors want to move out a substantial amount of equities, they will depress market prices, and when market prices fall by, let's say 20 per cent, investors will have to think again, because with a 20 or 10 per cent devaluation it is not worth liquidating your stock to move out – "It is only if you are the first one that you can do this, otherwise it will not work," Buira observed;
* *government debt*, such as treasury bills, in which case, if any significant amount is moved out, interest rates will rise, and investors may reconsider whether it would be wise to move out.

Buira also believed that the most important determinants of capital flows are the economic fundamentals of LDCs rather than the so-called push, pull or rejection factors from industrial countries.

Bernard Snoy, though agreeing with Griffith-Jones that in the long run the setting up of a global board of regulators might be an interesting proposition, stated that in the short run "it would be better to rely more on the International Monetary Fund as part of its surveillance mission to see to what extent the supervision of the markets could be enhanced to mitigate some of the possible negative effects of globalisation."

On the other hand, however, Snoy advocated further deregulation, because developing countries are still suffering from distortions in capital markets of industrialised countries. "They still need the dismantling of regulations in several industrial countries which prevent institutional investors, for instance pension funds or insurance companies, to invest as much as would be optimal in the emerging markets," he argued.

Snoy also pointed to two "plagues" Griffith-Jones had not dealt with in her paper: money laundering and tax evasion.

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"The laundering of money related to drugs is one of the greatest problems in Latin America, and precisely because of the progress made in financial technology it is very difficult to eliminate," Snoy said. The same holds true for tax evasion, he argued. "It is obvious that the globalisation and integration of world financial markets is making it much easier to evade taxation. Each country tends to be a tax haven for the residents of the neighbouring countries. It is a very, very difficult problem, which can only be solved in the very long term."

Ifigenia Martínez suggested that one should start thinking about universal taxation. "I would favour, for example, a universal income tax on the rich, and a universal energy tax on non-renewable resources," she said. Such a tax would have to be globally comprehensive, she added, and at this stage of international economic cooperation it was highly unlikely that universal taxation would become reality in the near future.

Martínez favoured the monitoring of international financial flows, among other things, to get a hand on the money laundering related to drugs, "which is very big for some countries and very destabilising too".

A third point Martínez put forward was that today's world recession makes it more important than ever for the financing of development in developing countries to be done as much as possible by mobilising internal resources and by fully utilising the savings capacity of each country. She referred to the United States, "which has a very low savings coefficient", and to her own country, Mexico, "where the top 20 per cent of the families earns about 60 per cent of the disposable income, which means that they have a huge savings capacity to finance the recovery and further development process."

Philippe Moutot observed that coordination is needed not only between supervisors or regulators, but also between market authorities and other authorities such as treasury officials. He also said that though one could advise a Global Board solution, or an IMF solution, it would be equally important to make sure that the information generated by markets was conveyed efficiently and swiftly to the regulators. "This transmission of information seems to me an important point," he said.

Peter Kenen stressed that one should distinguish sharply between securities that are issued and traded on the markets of the developing countries themselves and those which are issued and traded on foreign markets. "Securities that are issued and traded on the domestic markets contribute to the breadth of those markets – the point Mr. Gaspar made earlier – while those that are traded on the international market may contribute to the volatility of the domestic markets," he explained.

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Reply by Griffith-Jones

Stephany Griffith-Jones welcomed the variety of comments on regulation. She did not agree that one should not exaggerate regulation because it would carry a cost.

"I don't take that argument so seriously, because the cost of financial failure can be potentially very large and the regulation costs are minimal compared to such a major crisis. I think the argument to be taken more seriously is that one may lose certain efficiency gains if one over-regulates, because certain transactions which would reduce costs generally or contribute to a better allocation of resources will be avoided."

Griffith-Jones agreed with the gist of the comments made by both Percy Mistry and John Williamson on the instability of stock exchange markets. She disputed, however, Wiliamson's statement that a sudden selling of shares would only result in a drop in the prices of assets. There would also be an impact on the balance of payments, she said. "At a minimum, new investors would stop coming in and there would be an impact there."

Griffith-Jones also agreed with Philippe Moutot's point that there is a need for cooperation between the regulators, the monetary authorities and the market.

"There are a number of market bodies now which undertake quite a lot of self-regulation and they have a certain amount of international coordination. But there is a need to analyse whether the self-regulation – this is a big discussion topic now in the United Kingdom – is appropriate. Of course, self-regulation by market bodies has the advantage that regulators know the market very well because they come from the markets. But it also has the disadvantage that they are too close to the market, not only in the sense that there is a danger of malpractice but also that they don't look at things from the position of the public good."

Griffith-Jones was not surprised by the criticism of the Tobin tax proposal. "Any new form of taxation raises tremendous technical problems and political opposition," she said. However, she did fully agree that the Tobin tax would be only feasible if it were supported around the world. "If not," she said, "the loopholes would create more problems than it would solve." Griffith-Jones also agreed that it would be difficult to discriminate between speculative flows and other flows. "The technical problems are probably very large," she admitted. "But the potential revenues would also be very large," she stressed.

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Economic Reform and Debt Relief in Eastern Europe: Lessons from the 1980s Debt Crisis[1]

John Williamson

The primary thing that the creditors should learn from the debt crisis of the 1980s is that there are more important things in life than continuing to have debt serviced on the basis of the original contractual terms. That was hardly their attitude when the debt crisis broke in 1982. Walter Wriston's dictum that "sovereign countries do not go bankrupt" was the text of the time, and there were certainly banks that had acted on that dictum and that would therefore have been endangered had any large volume of sovereign debt gone unserviced. Hence enormous efforts were made to overcome the free rider problem to an extent sufficient to reschedule existing debt and provide enough "new money" (i.e. to recycle enough of the interest without formal interest capitalisation) to keep the debtors current on at least their interest obligations. These efforts succeeded in postponing the day when it was necessary to acknowledge that the debts were not worth 100 cents on the dollar, but the cost to the debtor countries ("the lost decade") was high.

In the first part of this paper I discuss three factors that helped shape the initial debt strategy and describe how those were eroded over time. The next section of the paper summarises what seems to me the best available explanation of the logic of the Brady Plan and the extent of debt relief that it provided. The final section discusses policy implications for Eastern Europe (interpreted broadly to encompass Central Europe as well as the former Soviet Union).

I. THE BASES OF THE INITIAL DEBT STRATEGY

The initial insistence that debt should be fully serviced whatever the cost to the debtor was presumably motivated principally by the perception that a number of major banks – primarily, though not exclusively, in the United

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States – would have been threatened with bankruptcy had there been any major interruption in debt service. Given fears that debt repudiation might prove contagious ("moral hazard"), this concern translated into an attempt to try and maintain service by all debtors, even those too small to have any individual systemic impact.

The concern about bank insolvency eased gradually, as the banks built up reserves and began the process of writing down the balance sheet value of their sovereign debt. In May 1987 Citibank announced that it was setting aside reserves equal to 22 per cent of the value of its loans to the problem debtors. From that time on it was clear that even substantial debt relief would not threaten the financial viability of more than the odd bank. The "debt problem" was from then on acknowledged to be a problem for the debtors rather than the banks.

The perceived imperative of supporting the banks by maintaining full debt service was reinforced by two intellectual phenomena. One was the conclusion of my colleague William Cline (1983) that the debtors' problem was one of illiquidity rather than insolvency.[2] If the debtor countries could expect to grow out of their problems within three or four years, as his projections suggested was likely, it would be foolish to jeopardise not just the financial stability of the banks but also the future creditworthiness of the debtors themselves, as debt relief would (it was argued) do.[3] Hence his prescription was for new money, to permit continued full servicing of the debt.

Cline's dichotomy has been criticised by many subsequent writers (e.g. Ahmed and Summers 1992), on the ground that a debtor that is known to be solvent ought always to be able to find a lender willing to provide it with temporary liquidity. However, that assumes a rationality in financial markets

2 Cline (1983, p. 45) noted the "classic distinction between a firm that has positive net worth but is illiquid and one that simply has negative net worth, and is therefore insolvent....To analyse whether the problem of developing-country debt is one of insolvency or illiquidity, it is necessary to examine the prospective path of [the "ex ante" balance of payments, given at least minimally acceptable growth rates] and debt...over the medium term...If the prospective external deficits are so large that there is no plausible way they can be financed...then the diagnosis must be one of insolvency. However, if instead the deficits are of a size that is consistent with reasonable magnitudes of financing, and especially if the prospective deficits relative to exports... show an improving trend, then the appropriate diagnosis is one of illiquidity." But he added that the conceptual distinction between illiquidity and insolvency was less clearcut for a country than for a firm, because of the absence of any social institution analogous to bankruptcy.

3 Debt relief means a reduction in the present value of a debtor's future debt service obligations. This is the traditional term for what the official world, seeking language to obfuscate the fact that it was doing what it had spent six years declaring to be unnecessary, decided to relabel by the hideous and unwieldy euphemism "debt reduction and debt service reduction" at the time of introduction of the Brady Plan.

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that is not self-evidently confirmed by their behaviour. To my mind a more convincing criticism of the dichotomy stems from recognition that it excludes motivations for not servicing debt other than a total inability to do so, such as a belief that there are more urgent uses for such foreign exchange as is available. (Cline's own qualification, noted in footnote 2 above, about the relevant concept of the balance of payments being an ex ante one involving "at least minimally acceptable growth rates in the debtor countries", already hints at that problem.)

In the event, Cline's projections proved over-optimistic, as many writers have pointed out over the subsequent years. Two recent studies, one by Dittus and O'Brien (1991) at the OECD and the other by Cline (1993) himself, have sought to pinpoint the reasons why. The former study points to much weaker commodity prices than forecast by the model and a failure to allow for capital flight. Cline qualifies the first of these factors by pointing out that the forecast recovery in commodity prices was delayed rather than nonexistent, since they returned to near the level forecast by his model by 1989. He also adds a number of other factors: the oil price collapse of 1986 (which was on balance unfavourable to the debtors, though with very strong distribution effects); the deceleration in world inflation and rise in real interest rates; and the failure to make allowance for the "internal transfer problem", i.e. the difficulty of mobilising fiscal resources from the private sector to pay interest on the government's external debt, which contributed to the inflationary explosion in a number of countries. He endorsed the conclusions of Dittus and O'Brien on the importance of capital flight, which accounted for some 80 per cent of the debt buildup up to 1987.

Another source of powerful intellectual support for the initial debt strategy came from a profound ignorance of history. It was widely believed[4] that default on sovereign debt was a historical aberration more or less confined to the 1930s, and carrying with it penalties – in the form of a lengthy loss of access to financial markets – sufficiently severe to deter any rational country from repudiating its debt. This view was reinforced by the prevalent ideological tendency among economists to assume that markets always know what they are doing, which implied that since the banks had been making a lot of sovereign loans there must be severe consequences to a debtor that stopped debt service, because otherwise the loans would not have been made.

4 I attempt to recall what I believed at the time. I do not recollect encountering those who were better informed, at least until the publication of Kaletsky (1985), whose striking opening paragraph read:
"For at least five hundred years, governments and nations have regularly defaulted on their foreign debts. Recent history suggests that sovereign lending debacles have followed a fifty-year cycle of monotonous predictability; today's problem borrowers were among the nations which defaulted in the 1930s, the 1870s, and, in some cases, the 1820s."

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As the decade progressed, we historically ignorant economists learned more and more about previous occasions when countries had had difficulty maintaining debt service, and had ultimately had their debt restructured in agreement with their creditors in a way that involved substantial debt relief. The earliest instance, which has been unearthed only recently (Sachs 1993), relates to an occasion in 1790 when Alexander Hamilton journeyed to Paris (then, as now, the headquarters of the creditors) to tell the mainly French holders of the bonds sold to finance the American War of Independence that they could choose from a menu of options that looks remarkably like those offered under the Brady Plan two centuries later. The creditors could accept discount bonds, involving a reduction in the face value of their claims but with the original interest rate maintained intact; or they could swap into par bonds, with the capital value intact but a lower interest rate; or they could stick with the original contractual terms, but in that case they would go to the back of the queue when the United States government did not have enough foreign exchange to service all the debt.

Soon after the outbreak of the debt crisis, a young banker reportedly assured his senior that there was no need to trouble himself about the danger that Mexican debt might be worth less than 100 cents on the dollar, since Mexico had always serviced its debt punctiliously. In a 1988 conference where the economic historians tried to educate economists about the history of debt restructuring, Vinod Aggarwal (in Eichengreen and Lindert, 1989) revealed that this was true for precisely the first six years of Mexican independence. In 1821, Mexico achieved independence; in 1824, it contracted its first loan in London; and in 1827 it stopped servicing that loan. Periodic renegotiation of that debt ensued for the following 59 years, including one innovative attempt at financial engineering where holders of Mexican debt were offered a swap into Texan land that Mexico had already lost as a consequence of the Mexico-Texas War. The matter was finally settled by the strong government of Diaz in 1886: despite a series of defaults, repudiations, conversions and forced reschedulings over the intervening years, the bondholders ultimately recovered their capital in full and got interest averaging 2.3 per cent per year on the 1824 bond issues and 1.1 per cent per year on the 1825 bond issues (as against an initial coupon of 5 per cent).

Mexico returned to the international capital market (initially in Berlin) in 1888, refinanced in 1899, defaulted in 1913, and reached a settlement with its creditors, involving debt relief of about 90 per cent, in 1942. A new cycle of foreign borrowing did not get under way until the early 1970s, and lasted until 1982. It did not seem so at the time, but in historical perspective the latest round is notable for the speed with which Mexico restructured its debt. Most other Latin American countries have had an equally chequered involvement with the international capital market, and most of the many

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restructurings in the nineteenth and first half of the twentieth centuries involved an element of debt relief. Nor is debt relief a speciality of the New World, nor did it end after World War Two. Prior to the 1980s there were in fact two major debt restructurings that involved very substantial debt relief. The 1952 London Accord restructured the prewar German debts inherited by West Germany, providing debt relief that Mike Faber (1990) estimated at close to 70 per cent. And in 1966 the creditors put the German responsible for gaining those very favourable terms (Herman Abs) in charge of negotiating the restructuring of Indonesia's debt following the fall of Sukarno; the IMF is reported to have estimated the resulting debt relief at 53 per cent (Faber 1990). Neither Germany nor Indonesia has been excluded from the international capital market since they were conceded debt relief.

In short, while sovereign countries don't go bankrupt or (often) repudiate their debt, it is historically quite abnormal for debtors that have encountered difficulties in maintaining debt service to be required to stick with the terms of their original contract, or even to maintain the present value of their debts intact. Among the few cases where attempts were made to avoid debt relief were inter-allied war debts following World War One; Argentine sterling-denominated debt in the 1930s; and sovereign debt to banks in the 1980s. Of those three, only the Argentine debt was ultimately serviced in full. But it is equally unusual for debtors to get away with a total repudiation of their debts (among major debtors, the Soviet Union following the establishment of Communism came the closest: even it eventually made token payments to redeem the Czarist bonds in order to win renewed access to the London bond market). In general creditors and debtors ultimately get together and agree to restructure the debt, with some combination of debt relief and cash-flow relief, and the creditors preserving a part of the value of their claims.

II. EXPLAINING THE BRADY PLAN

To what extent can one explain the terms on which the parties agree to restructure sovereign debt? This important question was obscured by excessive moralising in the early years of the debt crisis. At that time defiant debtors would declaim the immorality of placing debt service ahead of the needs of the hungry, while earnest creditors and their friends[5] suggested that continued servicing of debts according to the original contractual terms, or at least with the present value maintained intact, was an absolute moral imperative.

5 Of whom Martin Feldstein was perhaps the most outspoken.

It is by now widely recognised that this approach is unhelpful. It is more natural to postulate that both debtors and creditors act in their enlightened self-interest, servicing outstanding debt and extending new loans respectively when and only when they expect that to serve their interest. Of course, a debtor that earned a reputation for treating its debt service obligations casually would have to expect to find itself the target of whatever sanctions the creditors can command: the experiences of countries that have "opted out" (like the Soviet Union following the Communist takeover, and Peru and Zambia in the 1980s) have not suggested that this is a wise strategy.

It is, however, one thing to expect that debt will be serviced when the assumptions under which it was contracted are more or less satisfied, but quite another to treat the debt contract as devoid of implicit contingent clauses.[6] When expectations are disappointed, debtors think again, and creditors grumble but comprehend.

Those dissatisfied with the moralistic approach to debt restructuring were initially puzzled as to how it should be replaced. They appealed to an implicit (or sometimes explicit) model in which the debtor country had an exogenous but stochastic stream of foreign exchange receipts available for debt service, which was expected under most states of the world to provide insufficient foreign exchange to cover the full value of the debt service due. But even if the creditor was almost sure that the debt would not be serviced in full, why should it agree to a reduction in the contractual value of its claims on the debtor? There was always some tiny possibility that nature would be kind and enable the debtor to pay in full, thus giving an option value to preservation of the marginal claim.

Paul Krugman (1988) first formalised a rationale as to why the creditors might find it in their (collective) interest to agree to write down the value of the debt to something that the debtor could expect to be able to afford to pay. He argued that an unpayable debt service obligation had unfavourable incentive effects, resulting in a "debt Laffer curve". A debtor with a "debt overhang" would be obliged to pay over all (or most of) an increase in export earnings to its creditors, which would leave it with no (or minimal) incentive to undertake investments, including adjustment policies, that could be expected to increase future export earnings. Creditors collectively might thus share a common interest with the debtor in eliminating a debt overhang, although of course with many creditors it might be difficult to realise that interest because of the free rider problem.

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6 It would have been better if explicit contingent clauses had been included in the original debt contract, but the failure to include them does not mean that debtors can reasonably be expected to honor the original terms irrespective of developments that erode their capacity to pay.

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This analysis has been questioned on two grounds. One concerns its empirical importance (e.g. Cline 1990, p. 100, Diwan and Rodrik 1992). Calculations suggested that the "marginal tax rate" imposed by the banks was rather small (Diwan and Rodrik suggested as little as 2 per cent). The other argument (developed by Diwan and Rodrik) is that most investment is undertaken by individual firms rather than decided by the government, and that even a high "tax rate" on the country need not translate into a high disincentive at the level of the firm.

However, there is one context in which it is plausible to believe that the effect may have been significant, and which would not be captured by the empirical analyses mentioned above. This concerns the return of flight capital. It seems fairly clear that one reason for the reluctance of flight capital to return was the fear of measures of partial expropriation (devaluation, inflation, forced funding of liquid balances, capital levies, etc.) being resorted to in an attempt to generate the foreign exchange or meet the fiscal needs created by debt service. Hence debt write-downs that relieved such fears might induce a reversal of capital flight and thus contribute to the ability to service debt. Mexico after its Brady deal provides the classic example.

Diwan and Rodrik argue that a similar type of (collective) creditor interest in debt relief can arise in a more plausible way, from the existence of a liquidity constraint that precludes a debtor undertaking investments (including adjustment) that it regards as being in its own interest inasmuch as the ultimate benefits will outweigh the immediate costs. They argue that this problem cannot be resolved by voluntary new lending for two reasons.

The first reason involves the free rider problem again. Existence of a debt overhang means that, even though the marginal return to the creditors may exceed their opportunity cost of funds, they will not be prepared to put up money voluntarily because, as long as old claims are undiminished, the returns on new investment will be diluted by being shared with the old creditors. Resolution of the debt problem thus requires both new money and debt relief. The new money is needed to provide the liquidity that allows investment to be undertaken, and the debt relief is needed to allow the new creditors (in practice mainly the international financial institutions) to receive a competitive return rather than be exploited by the old creditors.

Second, they argue that although a government may be happy to undertake adjustment in return for new money, it may very well regard the use of additional resources to increase consumption as a more urgent priority still. Since the creditors would not get any return from the debtor's preferred use of new money, they would not lend more even if they could overcome the free rider problem, absent a way of ensuring that the debtor uses the additional funds to pursue its second-best policy in preference to its first-best choice. Conditionality provides the mechanism

to ensure that the debtor uses the extra money to invest rather than increase consumption.

This analysis suggests the logic of the main features of the Brady Plan, which may be summarised as (a) the debtor country pledges to adjust and accepts conditionality designed to ensure that it fulfils its pledge; (b) the international financial institutions (IFIs) police the conditionality, lend some of their own money, and orchestrate a deal whereby (c) the banks grant debt relief (though some may put up new money instead). The debtor country gains because it is better off with the investment than without, and conditionality provides the precommitment mechanism that allows it to get the investment. The banks gain because the new lending is in the collective interest of the creditors provided it actually buys adjustment. And the IFIs (like any banks that choose to make their contribution in the form of new money rather than debt relief) gain provided that the extent of debt relief is sufficient to enable the country to pay a competitive return on the new money (where that return includes increased earnings on any old debt that may be held by the new lenders). The limits of the deal are defined by the condition that each of the three parties gains (or at least does not lose). These limits can be extended by the details of the menu options offered to the banks, which allow the heterogeneous preferences of the banks to be translated into terms that are more favourable to the other two parties. (But banks still have to be compelled to select from the menu and not allowed to freeride.)

This account seems to me to provide us with an essentially complete understanding of the logic of the Brady Plan. It does not necessarily pin down the exact terms on which debt restructuring will be agreed, but it goes a long way toward explaining why and under what circumstances banks can be expected to agree to debt relief when a debtor finds it unreasonably onerous to continue servicing its debt on the original contractual terms.

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Table 1 Eastern Europe and the Soviet Union: Gross Debt, Foreign Currency Reserves and Net Debt in Convertible Currencies (billion dollars)

	1970	1975	1980	1985	1986	1987	1988	1989	1990
					Gross Debt				
Bulgaria	0.7	2.7	4.9	4.1	5.5	7.4	9.1	10.7	11.1
Czechoslovakia	0.3	1.0	6.8	4.6	5.6	6.7	7.3	7.9	8.1
Hungary	1.0	3.9	9.1	14.0	16.9	19.6	19.6	20.4	21.3
Poland	1.2	8.4	24.1	29.3	33.5	39.2	39.2	40.8	48.5
Romania	1.0	2.9	9.6	6.6	6.4	5.7	1.9	0.7	1.2
Yugoslavia	2.1	6.0	18.5	18.4	19.2	20.5	18.9	17.3	16.5
Eastern Europe	6.0	24.9	73.0	77.0	87.1	99.0	96.0	97.8	106.7
Soviet Union	1.6	15.4	25.2	31.4	37.4	40.2	49.4	58.5	62.5
Eastern Europe and Soviet Union	7.6	40.3	98.1	108.4	124.5	139.2	145.4	156.3	169.2
					Foreign currency reserves				
Bulgaria	.	0.4	0.8	2.1	1.4	1.1	1.8	1.2	0.6
Czechoslovakia	0.3	0.3	1.8	0.9	1.1	1.4	1.6	2.2	1.1
Hungary	0.2	0.9	1.4	2.2	2.3	1.6	1.5	1.2	1.1
Poland	0.3	0.6	0.1	0.9	0.7	1.5	2.1	2.3	4.5
Romania	.	0.5	0.3	0.2	0.6	1.4	0.8	1.9	0.5
Yugoslavia	0.1	0.8	1.4	1.1	1.5	0.7	2.3	4.1	5.5
Eastern Europe	0.9	3.6	5.8	7.3	7.5	7.7	10.0	12.9	13.2
Soviet Union	1.0	3.1	8.6	13.1	14.8	14.1	15.3	14.7	8.6
Eastern Europe and Soviet Union	1.9	6.7	14.4	20.3	22.4	21.8	25.3	27.6	21.8
					Net debt (deducting foreign currency reserves)				
Bulgaria	0.7	2.3	4.1	2.0	4.1	6.3	7.3	9.5	10.5
Czechoslovakia	.	0.7	5.0	3.8	4.5	5.3	5.7	5.8	7.0
Hungary	0.8	3.0	7.7	11.8	14.6	18.0	18.2	19.1	20.2
Poland	0.9	7.8	24.0	28.4	32.8	37.7	37.1	38.5	44.0
Romania	1.0	2.3	9.2	6.4	5.8	4.3	1.1	-1.2	0.7
Yugoslavia	2.0	5.2	17.1	17.3	17.7	19.8	16.6	13.2	11.1
Eastern Europe	5.2	21.4	67.1	69.8	79.5	91.3	86.1	84.9	93.5
Soviet Union	0.6	12.3	16.6	18.3	22.5	26.1	34.1	43.8	53.9
Eastern Europe and Soviet Union	5.8	33.7	83.7	88.1	102.1	117.4	120.1	128.7	147.4

Source: Economic Survey of Europe in 1991-1992, UN Economic Commission for Europe, New York, 1992. 332 p.

Table 2 Eastern Europe: Estimated Net Foreign Debt and Debt/Export Ratio, 1992

	Debt (billions dollars)	Debt/Export (percentage)
Bulgaria	11.5	345
Czechoslovakia	7.4	65
Hungary	18.0	169
Poland	50.0	357
Romania	3.0	73
Russia	77.7	204

Sources: Eastern Europe: Debt, EBRD 1992 Annual Economic Review; Exports, Exchange rates, OECD; Polish export figure from Polish embassy and is based on payments, not customs information.
Russia: Debt, Treasury, International Affairs (hard currency debt of the former Soviet Union); Exports, State Statistical Committee of Russia.

III. IMPLICATIONS FOR EASTERN EUROPE

A number of countries in the region have only modest levels of debt: Albania, the Baltic states, the CIS states other than Russia and perhaps Ukraine, the Czech Republic, Georgia, Romania, and Slovakia. The heavily indebted countries are Bulgaria, Hungary, Poland, Russia, perhaps Ukraine (if it succeeds in fending off the "zero option" offer from Russia to take over the whole of the external debt of the former Soviet Union[7], and the successor states of Yugoslavia. (See Table 1 for the evolution of the external debt of the main countries of the region, and Table 2 for estimates of current debt levels and debt/export ratios as a measure of the debt burden.)

Hungary has so far preserved its creditworthiness, and did not allow Poland's success in gaining substantial debt relief to seduce it into seeking similar treatment. This is one of those instances (like Indonesia versus

7 One might wonder why Ukraine has been so anxious to take over a portion of the debt of the former Soviet Union. There appear to be two reasons. One is the hope that inheriting a part of the debt will serve to consolidate its sovereignty, as has occurred with other successor states (like Ecuador, New Granada, and Venezuela after the breakup of Great Colombia in 1829, or Czechoslovakia after the dismantling of the Austro-Hungarian Empire in 1918). The other is scepticism as to whether the assets of the former Soviet Union (which have to be renounced as the counterpart to escaping an obligation to service the debt) are as negligible as the Russians have claimed, especially relative to the likely present value of servicing ex-Soviet debt. See Armendariz and Williamson (1993).

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Philippines and Colombia versus Mexico) which have cast doubt on the "moral hazard" argument that was so popular in the early days of the debt crisis. It seems that the disadvantages of losing creditworthiness are perceived to be so pronounced that there is little need to reinforce them by deliberate punishment of a debtor that encounters legitimate difficulty in maintaining debt service. Indeed, one sometimes hears suggestions that the Hungarians may have been exaggerating the rewards of virtuously maintaining full debt service, although Table 2 suggests that the burden of the Hungarian debt is quite moderate compared to the levels that were reached in many Latin American countries in the 1980s (where debt/export ratios were mostly well over the traditional prudent ceiling of 200 per cent). An important question would seem to be whether Hungary's success in attracting direct investment is due in any significant measure to its willingness to avoid a confrontation with its creditors.

Poland has already (with help from the Polish ethnic lobby in the United States) received a reduction of approximately 50 per cent in the present value of the servicing obligations due on its official debt. (This does not show up as a big fall in the stock of debt outstanding, presumably because most of the creditors chose the option of par bonds with a lower interest rate rather than discount bonds.) Poland's remaining aim is to persuade the banks to settle their (relatively modest) portion of the debt on comparable terms. Given the combination of vigorous export growth in recent years, the low interest rates that have resulted from the substantial debt reduction already achieved, and the absence of capital flight, its debt burden now looks manageable despite the high debt/export ratio shown in table 2.

It will be a cause for celebration when it becomes possible to start worrying about the need to restructure the debt of the *Yugoslav* successor states.

Bulgaria and *Russia* constitute the core of the present problem.[8] As asserted in the introduction to this paper and substantiated above, the primary moral that the 1980s' debt crisis suggests for the treatment of their debt by the creditors is the need to renegotiate its terms promptly, if necessary by the provision of substantial debt relief as well as the extension of maturities, when it transpires that servicing of the debt on the original contractual terms is not practical. With one crucial proviso, this is better done with goodwill and sooner rather than grudgingly and later, in particular because Mexican experience suggests that a debt settlement can be a potent instrument in combating one of the most debilitating problems from which at least Russia is currently suffering, namely massive capital flight.

8 If Ukraine were to succeed in taking over its share of the former Soviet debt, it would face similar problems.

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The proviso is that the debt reconstruction be done in support of an adequate set of policy reforms. Conventional wisdom holds that aid, of which debt relief is a particular form, is a double-edged sword: useful and perhaps even necessary to permit rapid economic recovery when a country finds itself in a difficult situation but has introduced the policy reforms needed to turn the economy round, but also potentially dangerous inasmuch as it can enable a country to postpone the policy reforms needed to initiate recovery. The debt crisis reinforced this view, since the easy access to bank finance[9] in the 1970s permitted the perpetuation of policies that would have been better changed, while the Brady Plan provided the financial relief that finally allowed countries like Mexico to start benefiting from their brave reforms.

The conclusion is that conditionality has a vital role to play. However much it may be resented by populists, the Diwan-Rodrik analysis summarised in the previous section explains why conditionality is not just in the interest of creditors-who otherwise may have no interest in the provision of aid-but also why it is in the interest of debtors-who otherwise must expect that there will not be much aid.

But suppose that the creditors decided to give massive aid without conditionality because of what they perceived to be an overwhelming political need to support the incumbents. Would this necessarily be in the interests of the debtors? That depends on the balance of political forces in the beneficiaries: if they have sufficient political cohesion to be able to implement the set of policies that are in their own best long-run interest even without the spur of conditionality, then creditor generosity would be pure gain. But the most persuasive justification for conditionality argues that this is an atypical situation, and that normally the reformers need bolstering against conservatives and/or nationalists who are attempting to obstruct the reforms that will benefit the country in the long run. To the extent that this is judged likely to occur in Eastern Europe (about 99 per cent likely in my view), debt relief should be made conditional on the implementation of economic reforms. One would certainly want to see any major consolidation of Russian debt conditional on Russia's real interest rate rising to at least zero (from its recent rate of about -80 per cent per year), since otherwise there is no hope of stemming capital flight.

The content of the needed reforms in many respects parallels those that were introduced in Latin America during the 1980s, although Eastern European countries have an even more ambitious agenda in the institutional dimension. In an earlier paper (Williamson 1990), I described the list of reforms that were being urged on Latin America and increasingly

9 Admittedly their lending was not intended by the banks to be aid, but it had the same effect in this dimension.

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implemented within the region as the "Washington Consensus" (a term that was not intended to imply that Washington institutions could claim any particular intellectual priority in having developed that reform agenda). These reforms can be summarised as follows:[10]

* *Fiscal Discipline.* Budget deficits, properly measured to include provincial governments, state enterprises, and the central bank, should be small enough to be financed without recourse to the inflation tax. This typically implies a primary surplus (i.e., before adding debt service to expenditure) of several per cent of GDP, and an operational deficit (i.e., the deficit disregarding that part of the interest bill that simply compensates for inflation) of no more than about 2 per cent of GDP.
* *Public Expenditure Priorities.* Policy reform consists in redirecting expenditure from politically sensitive areas which typically receive more resources than their economic return can justify, like administration, defense, indiscriminate subsidies, and white elephants, toward neglected fields with high economic returns and the potential to improve income distribution, like primary health and education, and infrastructure.
* *Tax Reform* involves broadening the tax base and cutting marginal tax rates. The aim is to sharpen incentives and improve horizontal equity without lowering realised progressivity. Improved tax administration is an important aspect of broadening the base in the Latin context. Taxing interest earned on assets held abroad ("flight capital") should be another high priority for broadening the tax base in the coming decade.
* *Financial Liberalisation.* The ultimate objective is market-determined interest rates, but experience has shown that, under conditions of a chronic lack of confidence, market-determined rates can be so high as to threaten the financial solvency of productive enterprises and government. Under that circumstance a sensible interim objective is the abolition of preferential interest rates for privileged borrowers and achievement of a moderately positive real interest rate.
* *Exchange Rates.* Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.
* *Trade Liberalisation.* Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 per cent (or at most around 20 per cent) is achieved. There is, however, some disagreement about the speed with which tariffs should be phased out (with recommendations falling in

10 This summary is drawn from Williamson (1991).

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a band between 3 and 10 years), and about whether it is advisable to slow down the process of liberalisation when macroeconomic conditions are adverse (recession and payments deficit).

* *Foreign Direct Investment.* Barriers impeding the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.
* *Privatisation.* State enterprises should be privatised.
* *Deregulation.* Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.
* *Property Rights.* The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.

All those reforms are as desirable in Eastern Europe as in Latin America. The same could be said about the social agenda that I reluctantly omitted from the "Washington Consensus" because social issues did not command much priority in Washington in the 1980s, but which could now be legitimately included.

In a number of these areas, certainly those listed below, the changes needed in Eastern Europe are far more profound than was the case in Latin America.

* *Tax reform.* Most socialist countries had relied heavily on siphoning off the profits of public enterprises and were therefore lacking a modern system of taxes on income and value-added.
* *Financial liberalisation* had to start by breaking up monolithic public-sector banks and creating from scratch non-cash payments mechanisms for the personal sector.
* *Privatisation.* In round figures the task was to privatise more than 80 per cent of the economy rather than the 20 per cent or so that was at stake in Latin America, including agriculture and shops rather than just public utilities and bits and pieces of manufacturing.
* *Property rights* were almost non-existent at the outset of reform.

In addition, it was necessary to create institutions and social norms appropriate to the functioning of a market economy – things that were a part of the cultural heritage of Latin America as much as of the developed countries, and that economists had not previously focused on. Bankruptcy laws and laws on corporate governance are the tip of the iceberg, which covers also all those other social constraints, many of them still poorly understood, that serve to produce rough harmony between the pursuit of personal gain and furtherance of the social good.

The experience of the international institutions with conditionality in Latin America and elsewhere has focused on a fairly narrow segment of this

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broad agenda, primarily fiscal (and monetary) discipline, exchange-rate policy, and financial and trade liberalisation. These topics, plus privatisation, have also provided the core of the conditionality operated by the IFIs in the East European countries. I am not sure that I would have wanted to see conditionality tied to (for example) the establishment or enforcement of bankruptcy laws (though the West does seem to have been rather feeble in the limited technical assistance provided in these areas where the terrain is novel). It is probably better that conditionality has stuck to the areas with which the institutions were already familiar, which have provided ample challenges. While we have all surely had our detailed criticisms of the advice provided on one occasion or another, I would rate it as having been broadly appropriate. In particular, the charge that the output decline could have been avoided or substantially mitigated by less strict macro policies looks increasingly unpersuasive.

One of the surest lessons of experience with conditionality is that the Bretton Woods institutions cannot force policy changes on a government that is united in opposing them. The leverage for conditionality arises when the reformers control some of the key levers of power and can have their internal political clout strengthened by access to external finance. The ideal time to come in with strong international support is when the reformers have succeeded in implementing their programme and the key question is whether the programme will be politically sustainable for long enough to give it a chance of working. January 1990 in Poland provides a classic example of how it should be done.

In several respects Poland seems by far the most relevant precedent when considering the possibility of support to Russia. It too had a big foreign debt, a thoroughly socialised economy[11], and had allowed a hyperinflation to develop during a chaotic first phase of liberalisation. If the reformers get a second chance in Russia, the West should aim to let them use it as productively as Balcerowicz did by stabilising at the beginning of 1990.

One element of support should be a consolidation of the debt as sweeping as that in Poland was, although the much smaller debt burden in Russia (relative to the size of GDP or exports) suggests that it would be appropriate to focus on cash-flow relief rather than debt relief. My own suggestion would be to provide for the whole of the outstanding public-sector debt to be consolidated into long-term loans, with a maturity of (say) 25 years, a lengthy grace period (say 10 years), and a substantial (but possibly decreasing) proportion of the interest being capitalised at the beginning, say for the first five years. One advantage of avoiding debt relief is that this would minimise

11 Although the agricultural sector had never been collectivised in Poland.

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the burden-sharing problem among the Western countries which arises from the enormous disproportion between the extent of past lending by Germany at one extreme and Japan and the United States at the other.[12]

As in the case of the Polish debt restructuring, it would make a lot of sense to avoid making all of the benefits of the restructuring unconditionally available immediately. In the Polish case the debt relief comes only after Poland has remained current on an IMF programme for three years. The leverage this provides to the IMF may have been crucial in preventing Poland reverting to populist policies that would have wrecked the prospects for the recovery it has since started to experience (Sachs 1993).

Another lesson of the debt crisis is the advantage of combining an obligation on each creditor to participate in a debt restructuring with an element of choice in allowing each creditor to select the particular way in which it would contribute. Concerted action is necessary to overcome the free rider problem, but none of the grand schemes to create a new institution to take over sovereign debt ever got off the drawing board, mainly because they all tried to force all the creditors to do the same thing. The Brady plan let each bank choose from a menu the option that best suited its particular circumstances and expectations, thereby making the obligation to contribute less onerous. This is a lesson that will certainly be relevant to the restructuring of Bulgaria's debt, much of which is owned by the commercial banks, as well as in the consolidation of the residual (bank) component of the debt of Poland and Russia.

IV. CONCLUSION

Debt restructuring is an effective way of helping finance a programme of economic reform, thus increasing the probability that it will be sustained long enough to start producing results. The experience of the debt crisis has set to rest exaggerated fears that debt relief would produce excessive moral hazard, and has indeed demonstrated that even the creditors have an interest in a prompt reconstruction of debt whose continued service on the original terms would be unreasonably onerous to the debtor. The main constraint on a speedy debt restructuring should not be such fears, but rather a concern that debt concessions only be made when there is reasonable assurance that they will be used to support the reform process rather than to delay its

12 If subsequent "aid" were all to take the form of loans on commercial terms, Russia could indeed end up as over-indebted. But burden-sharing considerations suggest that in that event it would be better to give new money, which will presumably be contributed according to the customary proportions, on concessional terms, rather than to grant debt relief on old debt.

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introduction. This criterion suggests that it is high time that a definitive Bulgarian restructuring was initiated, although it is not equally clear that the time is yet ripe in Russia. Until that time arrives, the traditional Paris Club process of annual debt renegotiations dealing with the debt falling due each year may be more appropriate.

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Comment on "Economic Reform and Debt Relief in Eastern Europe: Lessons from the 1980s Debt Crisis," by John Williamson

Richard Portes

I do agree very much with the basic truth of John Williamson's analysis. Nevertheless, I think there are some things to add.

The primary lesson of the 1980s for the creditors, as Williamson puts it, is that there are more important things in life than continuing to have debt serviced on the basis of the original contractual terms. I would regard that as a primary lesson for the debtors as well.

I quite agree with his analysis of why the initial debt strategy was wrong, with a few nuances. First, he says that the basis of the initial debt strategy was in part an exaggerated perception of financial fragility. On this issue of financial fragility, I would add that the Chairman of the Federal Reserve might have been concerned to avoid being labelled for his restrictive monetary policies as the architect of a new great crash (as well as a wish on the part of the Managing Director of the IMF to find a new role for that institution in the 1980s). To sort out ex-post what was happening in 1982-1983, we need much more archival evidence than is currently available.

Second, I would stress, even more than John Williamson did, the failure in the *initial* analysis of the debt crisis to allow for the internal transfer problem of the debtors: the domestic fiscal burden of debt service and the consequent pressures on prices and interest rates. There is a very good analysis of that, for example, in Cohen (1987). I think this is very relevant to the Hungarian case, to which I shall return.

The third point is on the history, the ignorance of which on the part of most participants is a theme in Williamson's paper. The historical lessons were in fact reasonably well understood, and several of us were trying to spread the message. Barry Eichengreen and I studied the full set of loans made in the 1920s, and in one of our papers arising from this work, we wrote: "Observers familiar with the history of international lending approached the debt crisis of the 1980s with a sense of *déjà vu* (Eichengreen and Portes, 1986). It was indeed *déjà vu* all over again. The first paper I wrote in this area was on East European debt, five years before the debt crisis began (Portes 1977), and I relied significantly on previous studies of the way in which creditors have dealt with debt problems over the decades, indeed the centuries. This was not totally unknown territory.

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Comment on "Economic Reform and Debt Relief in Eastern Europe: Lessons from the 1980s Debt Crisis," by John Williamson

Mario Sarcinelli

Professor Williamson's very stimulating and thought-provoking paper on debt relief may be viewed as an attempt to rationalise the Brady Plan: the debtor country accepts policy conditionality designed to ensure that it fulfils its repayment pledge. In return, it receives funding from international financial institutions and debt relief from creditor banks and creditor governments. The international financial institutions police the conditionality.

As noted by John Williamson, the underlying idea is that all involved parties may gain from the agreement. However, one of the points that I will make in this intervention is that it is far from obvious that all parties will gain. All that can be stated with certainty is that a deal will be struck only if all parties expect to gain from it.

In this regard, bankruptcy for a country is a very different matter than bankruptcy for a company. In most western countries, a company in default can be forced by its creditors – supported by the legal system – to accept a settlement which might involve a change of company policy, a management shake-up, or a sale of assets. Creditors may have the power to decide whether the debtor company should survive as a going concern or be liquidated. The creditors are often in a position to ignore the views and interests of the debtor.

When, on the other hand, a country goes into default, nobody can force it to sell its assets, change management or adjust policies to service its debt. Apart from episodical impounding of assets located abroad and belonging to the government in default, which is often threatened, but seldom resorted to, all the creditors are able to do is to make it look appealing to the debtor to 'choose' to service at least part of the debt and to pursue economic policies that will make this possible. The carrot is lending – even if coated with the medicine of conditionality – the stick might be sanctions, like restricted access to trade finance. The debtor can be persuaded to accept the policy conditions and a renewed commitment to repay only if the required sacrifices are sweetened sufficiently by new money and, possibly, by a formal debt restructuring.

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I would like to stress, however, that there may well be cases in which there is no package of policy conditionality and debt restructuring which benefits *all* involved parties.

The benefit to the banks of rescheduling assets or providing new money is that the package may finance investment and trigger policy adjustments that might enable the debtor country to repay at least part of the outstanding claims. But there are also costs to the banks. First, there are obvious risks associated with any provision of new money. Second, formal debt reduction may force the banks to recognise the associated loss in their balance sheets. Third, any debt reduction may signal to other debtors that banks are willing to reward defaults. Fourth, once a particular "debt reduction percentage" has been agreed with one debtor country in dire straits, there is a risk that this percentage will be regarded by other, less needy debtors as a minimum acceptable "reduction percentage". Fifth, if debt renegotiation becomes widespread even in the absence of serious distress on the side of the debtor, contract sacrosanctity and banking moral basis would be undermined.

From the point of view of the debtor country, the initial default might have been the result of an unresolvable liquidity strain or an insolvency situation due to a growing disequilibrium between the foreign exchange cash-flow and the foreign debt service. It might, however, alternatively have been the result of a deliberate decision based on a simple assessment of the costs and benefits of defaulting. One cost of defaulting is loss of access to capital markets - access which most countries wish to have so as to facilitate trade and to finance temporary current account deficits. Another cost is a possible loss of moral or political standing in the international community. The potential benefit is availability of funds which the country would otherwise have to use for debt service.

Once the country has defaulted, it may wish to assess the benefits and costs of participating in a Brady-type deal. The primary benefit would be new money and a distant possibility of eventually regaining access to international capital markets – access which would, incidentally, in many cases have been very limited even before the initial default. One cost associated with a Brady deal would be the loss of funds that the deal would absorb for the resumed flow of debt service payments. Another cost would be the imposition from abroad of policy conditionality.

Given these cost/benefit considerations, it is perfectly possible that the amount of new money and debt reduction that would be needed to make the package attractive to the debtor would exceed what the private creditors would be willing to provide. There the international financial institutions – but not the EBRD that is a fully project-orientated bank – enter the play. Since they enjoy preferred creditor status, their claims on the defaulted country cannot be reduced and in principle continue to be serviced. However,

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since the risk of default vis-à-vis international financial institutions is not absent, these institutions have an interest to insist on a bigger reduction on the part of the other creditors to improve the repayment chances for their own claims, which entails a serious problem of inter-creditor equity, and a smaller participation in providing new money. Money from international financial institutions could prove, therefore, insufficient to bridge the gap. In that case, additional money from a third party, presumably a country with strategic or other interests in the debtor nation, would be needed for a deal to be struck. But I would not say it is very realistic to expect that.

Professor Williamson's paper treats the distinction between commercial and official creditors quite casually. In practice, this distinction is important. It is much easier for western governments to accept and manage administratively a write-down for their own claims on foreign countries than to justify and have Parliaments legislate to facilitate the provisioning for a write-down of claims held by commercial banks. This is why Poland and Bulgaria have found official creditors amenable to debt restructuring agreements within the confines of the Paris Club – which deals exclusively with official debt – whereas neither of the two countries has come anywhere near a parallel agreement with their commercial creditors, despite years of on-off negotiations.

Regarding the moral hazard problem, I don't believe it can be shrugged off easily. The international finance and payments system involves contractual obligations and relies on mutual trust between the signatories to the contracts. For this system to work, there must be a widespread perception that any breach of contract is associated with significant costs. This is clearly the view of most western banks, a view which goes a long way towards explaining why it has been difficult for countries like Bulgaria and Albania to reach an understanding with commercial creditors.

The flipside of this argument is that the finance and payments system will also fail to function appropriately if the banks expect to be compensated for all the mistakes they have made. Much should be done to prevent the perception among western banks that they can in all cases claim financial help from their own governments to reach a debt restructuring agreement with debtor nations. Banks should never be allowed to feel they can make placements with no downside risk. That could, however, be the consequence of government-brokered restructuring of commercial creditor debt. To avoid this consequence, it will be important to intensify ex ante supervision of bank lending. Widespread and rigorous application of the Cooke ratio in international prudential banking regulation may be helpful in this regard. As you know, the Cooke ratio sets relatively high capital requirements for certain risky types of lending, including to certain country categories.

Are we sure that prudential regulation is the ex ante instrument to lower the very chance of occurrence of international debt crisis? Let us explore

somewhat the subject. A debt crisis is always rooted in overlending. In turn, the latter results from a fundamental externality in the working of financial markets. Even if each lender rationally takes into account the effect of its marginal lending decision on the chance of full solvency of the borrower, it will disregard the effects on the value of other lenders' claims. Market rivalry between lenders leads to failure by anyone of them to internalise costs and benefits impinging on lenders as a group. Overlending can occur even if market participants know perfectly well what they are doing. Of course, financial fads can only make matters worse, while assessments of borrowers' creditworthiness is far from precise and inter-temporally consistent.

If the markets cannot be expected to solve the problem autonomously, prudential regulation through capital requirements and rules on risk concentration is called upon to fill the gap. However, the instrument is designed to limit the negative effects of idiosyncratic risk borne by the intermediaries lending to individual borrowers, be they national or foreign, private or public. Yet a basic feature of lending to finance a project in a developing country and a fortiori in a CEE country in transition seems to be that the country risk often dominates the idiosyncratic one. As a result, the effective returns from lending to entities located in a particular LDC or CEE country are much more highly correlated than would be the case for a developed country. Therefore, what ex ante was thought to be a lending activity driven micro-economically by market opportunities becomes ex post, in case of a severe, adverse shock, a macro problem that ties the fortunes of all creditors together. Incidentally, a way to delink the idiosyncratic risk from the country one is the setting up of escrow accounts domiciled abroad for projects with a foreign-exchange cashflow – a mixed blessing owing to the macroeconomic drawbacks engendered by massive recourse to such a technique. The recent softening of the negative pledge clause by the World Bank goes in this direction.

Since foreseeing severe country-wide shocks is extremely difficult, transboundary lending, including sovereign lending, carries an additional element of risk that is not completely embodied in the ex ante pricing of funds. Nor overlending can be avoided completely by prudential regulation. The latter can only force creditors to mark their assets to market after the outbreak of the crisis and to reconstitute their capital base, thus speeding up the resolution of the crisis. That's why, I think, in this phase of the transition of CEE countries towards the market, it is in the interest of the stability of the international financial system to have the capital flow towards those countries assured to a great extent by foreign direct investments, western public entities which can count on official support or guarantee (e.g. Export Credit Agencies) and international institutions. For the private banks to play a much bigger role – for which

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they do not seem to be very eager – we have to wait for a consolidation and strengthening of the economic base, which will bring about a lower correlation between individual investment outcomes in case of a strong exogenous disturbance.

Let me finish by adding a brief comment on the country-specific analysis in John Williamson's paper. I will limit myself to a few clarifying facts. First, he states in his paper that Albania's debt is modest. While some Albanians may be happy to read this, I don't believe the assessment would be shared by the country's commercial creditors. In fact, with a high of 953, Albania's debt/export ratio far exceeds that of any of the countries listed in table 2 of Williamson's paper. Another point worth noting is that the debt/export ratio may in some cases be a deceptive indicator of the risk of default. Romania is a case in point. Although Romania's debt burden is small, it is quite hard for the country to finance its amortisation payments as it enjoys virtually no access to private foreign funding. In fact, Romania has had to draw on bridging finance from the BIS this year to avoid running out of reserves. A third important factual point is that the debt restructuring issues facing countries like Poland and Russia are quite different from those facing countries like Albania, Bulgaria and Hungary. For the former two countries, the bulk of the debt is owed to official creditors; for the latter three countries most of the debt is owed to private creditors.

The last two points I would like to raise regard the suggestion Williamson makes about the structure of debt rescheduling in Russia. It seems far too generous to me to consolidate the whole of the outstanding public sector debt into 25 years maturity loans, with a 10 year grace period and a substantial proportion of interest being capitalised for the first five years. If we take into account the fact that Russia is one of the richest countries in natural resources of the world, the question that comes immediately to our mind is that if we agree with Williamson's proposal, what are we going to do in terms of debt rescheduling with all the other poorer countries which will justifiably seek similar concessions in the future? The second point concerns the fact that the mere promise of such a generous debt rescheduling might wipe out any type of incentive for the Russian government to get on with its reform programme. Even if the benefits of the debt rescheduling are not made available immediately, and even is conditionality is enforced, the simple knowledge that the West is going to be so generous in the debt restructuring might seriously damage any hope of reaching political and economic stability in Russia.

Let me finish by thanking Professor Williamson for his thoughtful paper. In addition to the points I have commented on above, I find his historical account educational. It is instructive to be reminded that the U.S. and Germany are among the countries that have had their foreign debt reduced

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by their creditors. At least in the case of sovereign borrowers, it is possible on this very earth to have proof of the evangelic promise that "the last shall be first".

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The historically *normal* resolution of debt servicing problems has taken the form of a restructuring agreed between creditors and debtors, with some significant debt relief element and subsequent restoration of normal access to the capital market. Eichengreen and I found that the countries that did default in the inter-war period did not have inferior access to capital markets in the post-war period, relative to those countries that did not default.

My next point is on the "debt Laffer curver". I think that this analysis overemphasises the search for a Pareto superior solution, or resolution. If that is the way your mind is conditioned to go, you ask whether the country is on the wrong side of the debt Laffer curve; if so, a reduction in the nominal stock of debt will make both the debtor and creditor better off. In a paper by Daniel Cohen and myself (1990), we come to the conclusion that there are very few countries that are on the wrong side of the debt Laffer curve. So this is a relative weak case for debt relief. But that is taking for granted the basic hypothesis that you are looking for a Pareto superior solution.

The question is, Pareto superior relative to what? Relative to one hundred per cent debt service? Complete fulfilment of the initial contractual obligations? No, that doesn't seem to me to be the right way to approach the problem. Instead we should be contemplating solutions that involve some pressure by creditor country governments on the creditors, in particular the banks, to arrive at solutions that are *not* Pareto superior, but rather require the banks to take some loss. If one says Pareto superior relative to the valuation of debt on the secondary market, that is a different story, and than there is something to talk about.

Let us go on to the lessons of all this for Eastern Europe. Whatever one may have written about Eastern Europe debt long ago or recently, it has had no effect on policy, certainly not on the banks. If you look, for example, at what happened in the mid-1980s, the appropriate title of some part of this section ought to be not 'the lessons for Eastern Europe' but 'the lessons for the banks'. Because yet again, having seen Poland, Hungary and Romania get into trouble in the early 1980s, the banks contrived from 1985 to 1989 to raise Bulgarian debt from 4.1 billion to 10.7 billion. And spreads went down from about 100 basis points in 1983 on average for Eastern Europe to about 25 basis point in 1987. The rush to lend prevailed again, they had to get back at it. They didn't learn anything!

I would slightly disagree with Williamson on the analysis of which countries are in trouble. He wrongly omits Albania, whose debt export ratio, even in 1990, was almost 300 per cent and is now 500, 600, 700. Albanian exports are sufficiently close to zero that even a marginal variation affects the ratio considerably. On the other hand, one should not include, as far as I can tell, all the successor states of Yugoslavia, because both Croatia and Slovenia appear to have relatively manageable debt burdens.

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John Williamson's comments on the Polish deal reached with the Paris Club suggest that it was a great success. I would not be that positive. Firstly, why did it take so long? Why not before March 1991? The stabilisation programme was introduced at the beginning of 1990. Second, why have the banks not followed? Poland is still locked in negotiations with the banks. Why haven't the creditor countries put a lot more pressure on the banks to strike a deal on the same (or comparable) terms as the Paris Club? Third, to what extent did the deal really give the IMF such strong leverage as Williamson suggests in the Polish context? Even to the extent that it did, there are limits to this: the Polish government has just fallen. The political strains produced by all of this pressure have been considerable.

And then we get the Hungarian case. Williamson says the successful deal that Poland arrived at with his creditors didn't seduce Hungary. This suggests that he believes that Hungary definitely should not have followed that road, and I am not at all convinced.

It seems to me that Hungary was about as close an analogy with Mexico as you could get in Eastern Europe: extensive reforms already in place; a government that was certainly committed to further reform; and a very heavy debt burden. The Hungarian debt burden is not and was not moderate. Cohen (1991) shows that on all measures – what he calls 'debt per effective capita', growth-adjusted debt, econometric analysis of the secondary market prices – on all those criteria, Hungary was and still is one of the most indebted countries in the world. As Cohen puts it, Hungary was similar to Argentina, Brazil and Côte d'Ivoire, as opposed to Poland, which ranks similarly to Turkey and the Philippines.

The domestic fiscal consequences of maintaining full debt service can be crippling. In the Hungarian case, you are talking about 5 per cent of GDP in interest payments. And that has resulted in a great squeeze on investment, both public investment and also (with high real interest rates) private investment.

On Bulgaria and Russia, I couldn't agree more with the policy suggestions in the paper. Bulgaria now: it should have been earlier, but certainly now. Russia later. In terms of striking a comprehensive debt relief agreement, there is a major difference that is not pointed out in the paper: the Bulgarian debt is mainly to the banks, and the Russian debt is mainly to governments.

A penultimate point on the content of needed reforms. Williamson sets out the Washington consensus, and he tends to endorse Latin American solutions for Eastern Europe, with a few provisos. It doesn't really fit well in certain places. For example, the East Europeans do not really need to allocate more to education, and they certainly do not need to cut marginal tax rates, because there has not ever been a personal income tax in many countries. Moreover, that consensus omits anything about recapitalising the banks and dealing with enterprise debts and the debt overhang internally. All those, I think, are essential points.

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The main distortion, however, from looking at Eastern Europe through Latin American eyes, is to overemphasise macroeconomic issues. Thus Williamson comes out approving a relatively narrow version of conditionality, a macro version along traditional lines, and characterises the advice that has been given to these countries as broadly appropriate.

I think this gives the wrong emphasis. In particular, it endorses the predominant role of the International Monetary Fund vis-à-vis the World Bank. The Bank has considerable expertise in structural conditionality, in micro level conditionality, and it seems to me that that is where the emphasis should have been from the beginning.

The output decline that we have witnessed in Eastern Europe, Williamson says, could not have been avoided with less restrictive macroeconomic policies. I tend to agree with that, but most of us do criticise the policies and the conditionality that has been followed. I am not arguing so much for a more expansionary *macro*economic environment, as for more stress on the basic *micro*economic issues: for example, the financial restructuring which is necessary to create the capital market, which really has not been done successfully anywhere yet in Europe.

I finish simply by endorsing the final point of the paper: "debt restructuring is an effective way of helping to finance a programme of economic reform". Indeed, I was pushing that three years ago (Portes, 1991), partly on the grounds that in thinking about how one could get reasonable sums of aid to Eastern Europe, it seemed to me that politically for the Western governments, that was the most likely way to find significant amounts – through debt relief, rather than out of new allocations. I still believe that to be the case, and it is certainly overdue already for Bulgaria.

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Floor Discussion of the Williamson Paper

Lessons from the 1980s debt crisis

John Williamson's assessment of the lessons that can be learnt from the 1980s international debt crisis provoked many comments. Various participants were particularly critical of the so-called 'Washington consensus' to which Williamson alluded in his paper.

One of the most outspoken critics was Ricardo Ffrench-Davis. He observed that the tough adjustment policies applied in Latin America in the 1980s had resulted in serious setbacks in economic development, employment, investment, and social conditions, while many Latin American countries had made net financial transfers abroad which, as a proportion of GDP, "were larger than those made by Germany after the First World War". Production losses during the decade were calculated at US$40 billion per year, he said. As a consequence, per capita output was now still lower than at the beginning of the crisis. By the early 1990s, over 40 per cent of the Latin American population, i.e. 200 million people, were living below the poverty line, he said.

Although Ffrench-Davis agreed that, at the beginning of the 1980s, adjustment was clearly needed and had also yielded positive results such as lower inflation rates and increased exports, he felt that a much better approach than the one propagated by the 'Washington consensus' would have been possible. "Not enough time was provided for doing the adjustment in the right way, and funds were curtailed too sharply," he said. Consequently, Ffrench-Davis advocated a "thorough revision" of the adjustment recipe.

"It should be better adapted to the reality of each economy and to the capacity of its markets and institutions to respond, be more comprehensive (including the impact on social and environmental variables), and explicitly address the questions of what would stimulate investment and growth, what would be the impact on the poor, and how productivity could be increased. It is a grave error to think that the problems of a low level of investment and of poverty would be automatically solved solely by liberalising markets and by a passive State," he warned.

Ffrench-Davis put special emphasis on the need for designing a policy recipe that would stimulate productive investment "rather than financial activism".

"If countries are faced for five or ten years with real interest rates of 20, 30 or 40 per cent, and an idle production capacity of 20 or 30 per cent, you have a very discouraging climate for private investment," he observed.

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The experience of Latin America during the 1980s shows that one should rethink the reform policies that were applied, French-Davis noted. "I think this will be quite relevant for Eastern Europe as well," he concluded.

Stephany Griffith-Jones endorsed Ffrench-Davis' plea, stating that "the Washington consensus of adjustment" had demonstrated a poor record in encouraging investment. "This is clearly shown by empirical evidence, including research by the World Bank itself," she said. Like Ffrench-Davis, she also felt that the social costs of adjustment ought to be taken more into account.

Gunter Baer raised the provocative question of whether a debt crisis was unavoidable or even desirable. He asked this question because John Williamson seemed to argue that the cooperative strategy that was chosen to deal with the crisis had been useful and beneficial to all three major players involved. Obviously there were costs too, he said. He therefore wondered what kind of advice one could give to those countries in Eastern Europe that did not yet have a debt problem. "How to avoid such a debt problem in the first place, I suppose," was his reply.

Gerald Helleiner drew some lessons for Eastern Europe from the African experience.

"First, Africans are being told by everyone to open their countries to foreign investors. But investors have no interest in putting their money into places with a debt overhang, and I suspect there is a similar story in Eastern Europe. Second, the African situation has gone terribly bad because of the collapse of primary commodity markets. In the case of Eastern Europe there is a similar problem that western markets are not opening up. Third, there is this issue of the link between government assistance and the treatment of government debt, both at the debtor and the creditor government level, which continuously comes up in the African context, and which is coming up again now in Eastern Europe. Fourth, if you put up the IMF when the changes that are required are long-term, you run the risk of landing the IMF in a situation, as in the case of Africa, which it is not equipped to deal with."

Percy Mistry argued that – though the debt problem of developing countries had become more tractable through restructuring, cancellation and conversion – private and bilateral debt had been partially offset and replaced by far less flexible multilateral bank and IMF debt. "In their liability portfolios debtor countries now have too large a proportion of hard and rigid debt service obligations to institutions which have, since 1987, been extracting instead of injecting real resources from severely-indebted countries. From being the solution as lenders of last resort for new money between 1982-85, multilateral lenders have now become the problem for most indebted countries."

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The debt problem

Drag Avramovic communicated the results of some work he had done recently on the question of whether the debt problem is really over. "Given the completion of the Brady Plan arrangements, and the euphoria that the debt crisis is over, I asked myself: how large is the residual debt problem?" Avramovic defined 'problem countries' as those with arrears that exceed 20 per cent of their scheduled debt service. On this criterion, there are 61 countries still in trouble.

"This is a very large number," he said, "consisting of 35 countries in Sub-Saharan Africa, 12 countries in Latin America, 8 countries in the Middle East and North Africa, and 6 countries in Asia. The total population of these countries is 770 million people, and the average per capita income for the group is 460 dollar, which is substantially below the poverty line which the World Bank is using. To whom is this amount owed? To bilateral official creditors, to the private sector – commercial banks and suppliers – and to the multilateral financial institutions."

Mahbub ul Haq advocated that special attention should be given to military debts. "I think we often ignore military debts in our analysis. However, in many countries they are larger than civilian debts. I know the figures for Pakistan, but I am prohibited from revealing them by the official secrets act. They will send shivers through the IMF. I know that in the IMF they have begun the analysis of Egyptian military debt, taking 5 billion dollars as a starting figure and then raising it to more than 40 billion dollars; it will turn out to be larger than civilian debts. But yet, somehow, in all the discussions in the IMF on conditionality, and on debt ceilings, they normally apply to development debts, not to military debts, and they enable the governments to incur more military debts. I think something has to be done now on military debts."

Peter Kenen observed that economic difficulties sometimes are unjustly ascribed to the debt problem. Referring to the case of Hungary, where it is argued that the debt burden has substantially crowded out domestic investment, he stressed that the key issue was the domestic banking system.

"There is every evidence of a shortage of bank credit to the new private sector in Hungary. Most of the analysts I have talked to tend to trace that to the difficulties of the banking system and not to the size of the debt burden," Kenen said.

Frans van Loon reported that, from the perspective of a banker, the view on the debt problem had changed dramatically.

"Certainly over the last two years or so, the way in which bankers have been looking at the question of debt has changed very profoundly. The idea of crisis is totally gone. The way in which bankers look at the problem

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now is much more one of flows than of stocks. They put more emphasis on finance as the quickest going element of economies worldwide, on the integration of various elements in the financial world, on the disappearance of previously important divisions between, say, commercial banking and investor banking, between insurance and banking, etc. All those elements which used to be looked at and regulated separately are gradually changing. The integrated financial markets are taking a much larger slice of economic activity generally, and even more so in the developing countries. So, in looking at flows, the interesting thing is that it is not the banks that are increasing their flows but the other elements of the financial world, such as foreign direct investment and securities. Cross-border flows are increasing in absolute and relative terms to everything else. That is the point, in my opinion. One should therefore look at the improvement of the system, at the allocation of savings and credit worldwide, rather than at stocks."

Barry Herman wondered whether debt relief would lead to a cash flow gain, given the fact that the value of the debt does not change very much as a result of debt restructuring under the Brady Plan.

"I mean, the enhancements that are given as part of the debt restructuring are not free. If they are financed by regular stand-by arrangements from the Fund they are fairly short-term loans. So if there is no benefit in cash flow terms, I suppose there will have to be one in terms of regularising the situation."

Comparing the Latin American to the Eastern European debt situation Onno de Beaufort Wijnholds agreed that there are both common aspects and important differences.

"One obviously is that the amounts involved with regard to Eastern Europe are much smaller, in both absolute and relative terms. So from the systemic point of view it is a much more manageable situation. Whether this means it is easier to solve I very much doubt. Probably precisely because it is not so much a systemic risk some parties are dragging their feet more than they have done in the Latin American case. Another difference is that most of the external debt of Eastern Europe is contracted with governments rather than banks. A third one is the conditionality, on which I very much agree with what has been said by Mr. Portes."

Philippe Moutot slightly disagreed with Richard Portes' statement that the World Bank rather than the IMF should have played the major role in Russia.

"I am not sure that the choice is simply between IMF conditionality or World Bank conditionality, or between putting one before the other. It is a bit more complicated. The problem is that the pace of progress on the macroeconomic side is very dependent on the pace of progress on the structural side, and vice versa."

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Bernard Snoy believed that Hungary had been right in its decision to service its debt punctually. It had been rewarded with large external flows, he said.

"Hungary has received more foreign direct investment than all the other Central and Eastern European countries put together. It has maintained access to the bond markets as well as to bank credits, and it has accumulated reserves. The good debt management has also underpinned its structural adjustment. I therefore have some doubts about the validity of findings that foreign direct investment has little to do with punctual debt servicing. In fact, foreign direct investment is based on that immaterial element called confidence, and this would certainly have been jeopardised if Hungary had given signals to the market that it wanted to reschedule or to get debt relief. As Mr. Kenen has said, the problems of Hungary in continuing adjustment lie elsewhere. They are situated in the reform of the financial sector and in the further reform of enterprises."

Snoy also doubted whether the generous debt reduction deal obtained by Poland had been so beneficial to the country.

"That very generous treatment has been associated mainly with political pressure, especially from the United States. And I wonder whether Poland is really reaping the benefits of that debt reduction in terms of foreign direct investment and when it will regain access to bank financing in the capital market."

Mohamed El-Erian followed up on this point, stating that debt restructuring involved costs as well as benefits.

"The very act of debt restructuring triggers a number of regulatory treatments in industrialised countries that immediately limit your access to external financing, to bank financing, to equity financing. So when one talks about debt restructuring for countries like Hungary, one has to pay close attention to the cost, and not only to the benefit."

Finally, Jan Tinbergen wanted to remind the participants that the developing countries would have had far less of a debt problem if the industrialised countries had given aid according to the 0.7 per cent norm. "We should never forget that the debt would have been only half as large if all developed countries had made available as development assistance the 0.7 per cent of GNP that was agreed to be the norm not only by the General Assembly of the United Nations, but also by the OECD."

Williamson's reply

John Williamson could take up only a few points of what he felt had been "a very interesting, stimulating and constructive debate".

On Gunter Baer's question as to whether debt crises are unavoidable, or even desirable as a way of imposing adjustment policies on debtor countries, he answered that he thought they were indeed unavoidable.

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"From time to time there will be some miscalculations. Unless we start learning how to build explicit contingent clauses into the loan contracts, there will be a necessity to re-contract at some stage. It seems to me that the best way to do that, as I suggested last year, is by establishing an International Debt Restructuring Agency."

Williamson did not think debt crises were desirable as a way of getting adjustment out of the debtor countries. "The changes in policy in Latin America were fundamentally a case of social learning. The countries saw what was working in East Asia and began to try to copy it. It was much more this type of effect rather than that they were forced to change their policies because of conditionality."

Addressing the question raised by Barry Herman as to how one can evaluate the outcomes of debt renegotiations, Williamson distinguished between three forms of relief.

"One is debt relief, which reduces the present value of the debt outstanding. A second form is cash flow relief, which is directed at interest payments in the near term. And the third one is regularising the situation, so that it becomes possible to go back to international capital markets, or even more importantly, to get capital repatriation. Now, the latter element is presumably going to be there anyway, but as between the first two elements, debt relief and cash flow relief, there is a trade off that a country can get more of one if it accepts less of the other. So one should ask which is going to be the most valuable one in each particular situation."

Williamson accepted the legitimacy of the criticism by Ffrench-Davis, Griffith-Jones and Martínez that IMF conditionality did not concentrate enough on the level of investment. However, he felt that, for instance, Mexico had made important investments over the last decade.

"The benefit that Mexico has got out of the adjustment is that it has become a serious exporter of industrial products. That is a major and important adjustment which places it in a much better situation to be able to grow in the future."

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G-7 Economic Coordination and Developing Countries

Richard N. Cooper

This paper addresses the question to what extent, if at all, better economic policy coordination among the major industrialised countries[1] can be economically helpful to developing countries, taken as a group. The major industrialised countries can influence the economic prospects of developing countries through three quite different, although possibly related, tangible channels:

1. by setting a "tone" of the overall world economy in terms of growth in aggregate demand;
2. by establishing the degree of ease or restrictiveness with which products from developing countries can enter their markets;
3. by providing savings, both public and private, to developing countries to foster their development.

These three channels, on which we will focus, ignore what is undoubtedly the most important but less tangible influence, namely new ideas, both conceptual (e.g. the very idea of economic development as something that can be achieved through conscious and deliberate government action) and practical, in the form of new technologies, management techniques, or approaches to economic policy.

We will first address the implications of macroeconomic developments of trade policies, and of resource flows in the major industrialised countries for developing countries. In the second part we will turn to the possible role of better G-7 coordination in influencing overall aggregate demand, openness of markets, and transfers of savings.

I. THE IMPLICATIONS FOR DEVELOPING COUNTRIES

Macroeconomic policies

The G-7 countries together accounted for 61 per cent of gross world product (GWP) in 1990, and other OECD countries contributed an additional 11 per

1 The G-7 comprise the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada, ordered by magnitude of gross domestic product in 1990. I use G-7 as a shorthand for a process that also involves the OECD and, to a less extent, the IMF.

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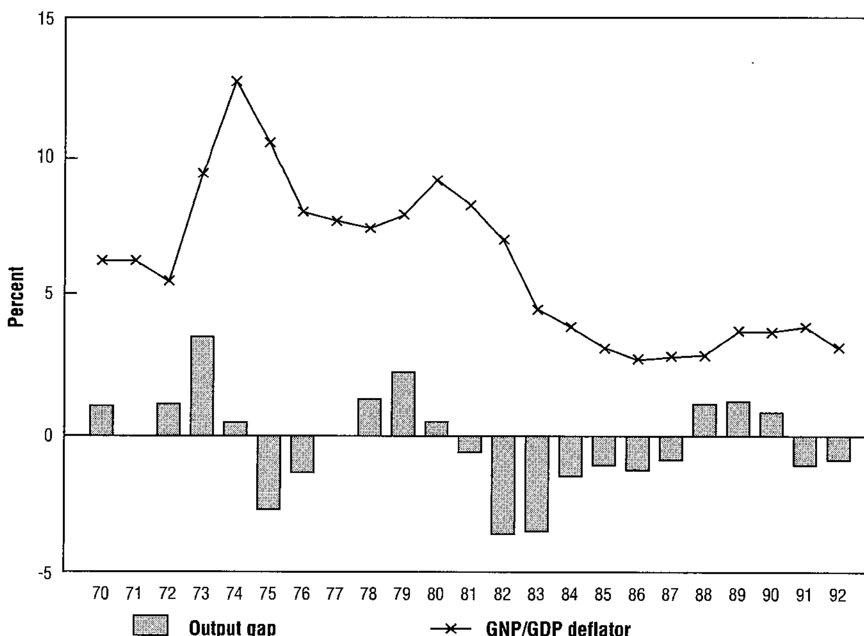
cent. Their collective actions therefore determine the overall tone of the world economy. Moreover, they are not constrained by a severe shortage of foreign exchange or lack of access to foreign capital, as many developing countries are, so they can frame their policies with little regard for the short-run implications for their international payments, although of course they must be concerned with their levels of external debt in the long run.

The G-7, and OECD as a whole, clearly operated their economies below capacity during the 1980s, as manifested by higher-than-normal unemployment rates and lower-than-desired rates of capacity utilisation. By the end of the 1980s these economies seemed to be operating at or even modestly above potential, but economic slack re-emerged during the early 1990s (see chart 1).

Chart 1 Price and Output Gap Developments in the Seven Largest OECD Economies, 1970-'92



Note: Based on 1987 GDP weights and exchange rates. The output gap is defined as the difference between actual and potential output relative to potential output. A positive value means that the economy is operating above its potential and a negative value that there is slack in the economy. GNP/GDP deflator is calculated as percentage change from the previous year.
Source: OECD Economic Outlook 49 (July 1991).

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For example, in 1984 the United States is estimated (by the OECD Secretariat) to have operated 3 per cent below its potential output, Japan at 1.7 per cent below its potential, and Germany at 6.7 per cent below its potential (as reported in McKibbin-Sachs, 1991, p.106).[2] If the G-7 economies had been run at their full potential, their demand for the products of developing countries would clearly have been higher. Given the economic slack that prevailed in many developing countries during most of the 1980s, and the fact that many of these economies were constrained by lack of foreign exchange, this additional demand could generally have been supplied by them, thus generating higher incomes and permitting greater imports. But running the G-7 economies at potential would also, arguably, have led to higher interest rates, thus increasing debt service obligations of those many developing countries that had large external debts. Servicing those debts at higher interests rates would have reduced the ability of developing countries to import, thus (given their dependence on imports as essential components of production, and of investment) reducing output and incomes in developing countries. What would the net effect of these conflicting factors have been?

Unfortunately, and perhaps surprisingly, we do not know. To answer the question properly requires a full, adequate model of the world economy, one that includes plausible structures for developing countries. But such work is still in its infancy. Important but still relatively primitive exploratory work can be found in Currie and Vines (1988) and by Muscatelli and Vines in Bryant et al.(1989), in both of which the developing world is characteristically modelled as a single entity exporting primary products to a unitary "North," which in turn exports manufactured goods to the South.[3]

There are several reasons for this surprising deficiency, warranting a brief digression on the methodological problems of macroeconomic modelling of the world economy.

Part of the problem concerns disagreements over how best to model the world, or indeed any complete economy, and in particular over the balance to be struck between effectiveness for short-run forecasting and model-simulation, on the one hand, and consistency of the long-run, usually

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2 For a discussion of the concept of potential GDP and output gaps, with estimates for major OECD countries, see Torres and Martin, 1990.

3 Extensive work on interdependent global systems began seriously only in the 1980s. A survey can be found in Cooper (1985). Important new work appears in Buiter and Marston (1985). An extensive examination of global empirical models can be found in Bryant et al(1988). An early policy simulation of an interdependent system is in Cooper (1969). An extensive recent effort is McKibbin-Sachs (1991). None of this work focuses on developing countries, although McKibbin-Sachs identifies two groups of developing countries, exporters of oil and of other raw materials.

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presumed to be steady-state properties of the model. Models focusing on the short run are usually driven by demand, those focusing on the long run by factors that affect potential output. Models focusing on the short run with reasonable good forecasting properties have regularly been constructed, but they typically neglect changes in outstanding debt and in the capital stock. These factors cannot be neglected in the long run, and economists differ in their judgements over the degree to which their neglect in the short run will introduce significant errors in policy simulations.

Full-fledged models with an interesting degree of detail were beyond reach until relatively recently, but advances in computational capacity have now made it possible to construct and run very complicated numerical models, which of course require quantitative estimates for the structural coefficients. A second problem concerns disagreements over the values of these structural coefficients, and in particular over the relative importance in determining output and prices of stock variables (e.g. debt or capital stock) as opposed to flow variables (e.g. debt service or new investment), and over the role of expectations in price formation not only for financial assets, but also for primary commodities that have some asset-like characteristics. There is no convincing way to estimate the coefficients or empirically validate quantitative guesses from history covering the relatively short period of 25 years of (barely) adequate data.

For example, in a model noted for its attention to balance-sheet consistency and stock-flow relationships, McKibbin and Sachs (1991) find that an output-increasing fiscal expansion in the United States will *worsen* the terms of trade both of oil-exporting countries and of non-oil exporting developing countries (that are assumed to export only industrial materials). This runs strongly against the more traditional view, recently re-asserted by Gilbert (1990) on the basis of simple regressions, that increases in industrial output in the OECD countries, whatever its source, will improve the terms of trade of primary-product exporting developing countries. We will revert to these contrasting results below.

In addition, the interest rate continues to play a much more important role in influencing investment in economists' models of economies than it seems to play in actual economies, insofar as one can judge from empirical attempts to estimate the quantitative role of interest rates.[4]

Moreover, we must face the *possibility* that a full-fledged model of the world economy, necessarily a system of non-linear differential equations, will be "chaotic" in the technical sense that it does not converge to a well-defined

4 For instance, Gilbert and Palaskas in Winters and Sapsford (1990) find no impact of interest rates on the world prices of six important primary products: cocoa, coffee, copper, rubber, sugar, and tin.

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equilibrium even in the absence of new shocks exogenous to the model, but rather continues in unpredictable non-periodic motion, perhaps confined to some given range of the endogenous variables. Such systems are known to be highly sensitive to initial conditions. Since it will never be possible to express initial conditions completely and with complete accuracy, such systems, although deterministic, become highly unpredictable after a period of time; only the near-term can be predicted reasonable well with some robustness to error or incompleteness in specification of the initial conditions.[5] McKibbin-Sachs (1991, pp.43-44) report that their model, while highly non-linear in form, performs very similar to a linear model, and indeed most of their simulations and policy experiments are done in the (log)linearised version. The same is apparently true of John Taylor's highly non-linear model.[6] The reason is straightforward: these models *impose* a long-run equilibrium on the model structure, to assure consistency over time, especially with respect to forward-looking expectations. This imposition of stead-state equilibrium, however, represents an expression of faith in the strength of the adaptive mechanisms of modern economies, rather than an empirical finding. It raises in a different form the problem of empirical validation.

A further problem arises in the proper specification of the "South." This is a convenient collective term for all poor countries. But it is analytically troublesome. The "South" comprises over 125 countries which range in per capita income (1990) from $80 (Mozambique) to $7050 (Saudi Arabia). They have very little in common apart from being poor relative to most OECD countries. They cannot engage in collective action, so cannot be treated as a policy-making entity, even though of course individual countries pursue policies responsive to world economic developments. The standard stylisation is that developing countries produce and export primary products, and import manufactured goods. With growth over the past 25 years in the importance of oil in world trade, and with a different system for pricing world trade in oil, it is at a minimum necessary to distinguish between oil-producing developing countries and others. Behaviourally, some (but not all) oil-exporting countries are more like developed countries, in that they are not chronically short of foreign exchange and hence have some latitude to frame their economic policies without regard to short-run availability of foreign exchange.

Inspection of the structure of world trade in the late 1980s reveals that some industrialised countries are large exporters of primary products,

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5 See Ekeland (1988), chapter 2 and appendix 2; or Ruelle (1991), chapters 10-12. Also Baumol and Benhabib (1989).

6 Communication from Warwick McKibbin.

especially foodstuffs, as indeed they have always been, and that developing countries are big importers of primary products, especially oil and foodstuffs. Moreover, more than half the non-oil exports from developing countries now consists of manufactured goods.[7] So it is no longer appropriate, if it ever was, to identify the prices of primary products (including or excluding oil) relative to manufactured goods with the terms of trade of (all or non-oil) developing countries. Yet this assumption has continued to dominate modelling of North-South economic interchange (e.g. Vines-Muscatelli in Bryant(1989) or McKibbin-Sachs (1991); but contrast McKibbin-Sundberg (1993) and Allen et al.(1992), where smaller groups of developing countries are modelled differently).

The proper characterisation of developing countries would therefore need to involve a minimum of three by predominant export: oil, non-oil primary products, and manufactured goods. For some purposes the second category should be sub-divided into those that export predominantly foodstuffs and beverages, and those that export industrial materials, agricultural or mineral. Yet many developing countries, particularly the larger ones, like developed countries are quite diversified in their exports. Furthermore, they show wide variation in the level and structure of external debt, a factor that is especially important in assessing the impact of macroeconomic developments in the G-7 on developing countries. Thus it would be better still to focus the problem at hand more precisely, and model the components of the "South" that are of special interest, e.g. Sub-Saharan Africa or South Asia, rather than lump all developing countries together.

Having said all this, I will offer an order of magnitude estimate of the impact on export earnings of developing countries that would have occurred if the G-7 had operated their economies at potential output during the 1980s, rather than considerably below potential as they did. In doing so I make several important assumptions: First, I assume that output was maintained at potential with that combination of fiscal and monetary policies that would have left nominal interest rates on the path they actually experienced, i.e. fiscal expansion would have been accompanied by sufficient monetary expansion, overall, to prevent a rise in interest rates. Thus debt service would not have been higher on account of higher interest rates.

Second, oil prices would have followed the same path they actually followed. This is a plausible assumption through 1985, but the sharp 1986 drop in oil prices would have been unlikely in the presence of stronger G-7

7 In 1986 56 per cent of exports of non-OPEC developing countries were manufactured goods. Sixty-six per cent of world exports of non-fuel primary products originated in the developed economies, compared with 23 per cent in the non-OPEC developing economies (the remainder came from OPEC and centrally planned economies). Figures from Gilbert (1990).

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demand, since Saudi Arabian output would not have fallen as sharply as it did in 1985.

Third, exports from developing countries were not constrained by limitations on supply; that is, exports could have expanded readily in response to stronger demand, perhaps with additional investment over the decade. "Readily" does not necessarily imply at constant cost, since, as we shall see, stronger demand would have raised the prices of non-food primary products somewhat.

Fourth, inflation in the industrialised countries would have followed the same path it actually followed. Growing at potential is not inconsistent with maintaining a non-inflationary environment. In fact, however, inflation is unlikely to have come down so rapidly without the recession of 1982, with its downward pressure both on prices and on wages. However, a somewhat slower decline of inflation could be accommodated in the calculation that follows, with the numbers scaled up to allow for the inflation.

Fifth, industrialised countries continued to keep their markets at least as open as in fact they were. For reasons to be discussed below, this is a reasonable assumption, and indeed under the hypothesised circumstances the industrialised countries very likely would have been more open to exports from developing countries, particularly manufactured goods.

Finally, no allowance is made for the additional direct investment that probably would have been made in developing countries in the presence of more abundant corporate profits in the industrialised countries.

The G-7 dropped below their potential output in 1981, fell short by about 4 per cent in 1982 and 1983, recovered to about 2 per cent below potential in 1984-86, and then gradually restored output to potential (which was lower than it might otherwise have been because of weak 1981-87 investment) in 1988. Industrial production drops more than GDP when demand is slack, as in the early 1980s, and with it drops the demand for primary products that are inputs into production. A rise in aggregate demand will be accompanied by a greater increase in industrial production (by a factor of perhaps 1.5), an increase in demand for industrial materials roughly proportionate to industrial production, and a rise in the price of industrial materials from their depression lows (by a factor of 1.9 until the slack has been eliminated – see Gilbert (1990)). The demand for oil will also rise relative to what it would be otherwise, assumed proportionate to the increase in GDP, even though the 1979-1980 oil price increases were inducing oil conservation in all activities. Finally, higher incomes will result to greater purchases of manufactured goods, from developing countries among other sources, roughly in proportion to the increase in income. Putting all these factors together suggests that annual exports from developing countries as a group would have been $10 to $45 billion higher during 1981-87, depending on the year, or

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about 5 per cent of their exports during this period, of which most would have accrued to the non-oil exporters (see Table 1). This increase in earnings would not have been enough to cover the external borrowing that took place in the period ($116 billion in 1982, $85 billion in 1984, $81 billion in 1986). But it would have eased considerably pressure on the developing countries to compress their imports and, as a consequence, their production.

Table 1

	Shortfall from G-7 Potential GDP (%)	OPEC Exports	Exports by non-Opec Developing Countries	Estimated Impact
		($ billion)		
1981	0.8	281	355	10
1982	4.0	211	341	45
1983	3.8	181	352	40
1984	2.0	166	387	25
1985	1.8	153	381	25
1986	1.9	112	393	25
1987	1.0	128	488	15

Sources: OECD, IMF, and author's calculations

This kind of calculation involves partial equilibrium analysis at its most primitive, but it provides a plausible order of magnitude figure of the impact of effective full employment policies on developing countries, and at this stage is as defensible as any of the still primitive attempts at general equilibrium analysis. Of course, if any of the first five assumptions specified above were relaxed, the estimate would be qualified, e.g. to allow for higher interest payments on debt or higher payments for oil imports.

There are two respects other than better macroeconomic management by which the G-7 can help the developing countries: by opening their markets to products from developing countries, and keeping them open; and by transferring resources to developing countries in forms that enlarge and improve the efficiency of the capital stocks there. Both are related to aggregate demand in the G-7 insofar as maintenance of full employment permits and encourages a liberal trade policy, and insofar as high profits permit and encourage direct foreign investment and provision of foreign assistance. But they are logically separate from global aggregate demand.

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Trade policies

As a generalisation, the major industrial countries have maintained open markets in recent years, and indeed opened them further during the 1970s and the 1980s, as agreed reductions in tariffs during the Kennedy Round (1967) and the Tokyo Round (1979) of multilateral trade negotiations were phased in over eight years following the conclusion of each round. The Tokyo Round, for instance, resulted in an average reduction in tariffs into the European Community, Japan, and the United States on non-agricultural products by about 30, 42, and 44 per cent, respectively, comparable to the 35 per cent reductions under the earlier Kennedy Round (Anjaria et al, 1982, Table 46). In addition, all three major areas in the early 1970s introduced the Generalised System of Preferences (GSP), conferring duty-free treatment to many manufactured goods from developing countries. And the United States in 1983 inaugurated the Caribbean Basin Initiative, which provided more extensive preferential coverage to goods originating in the Caribbean area (for a discussion of the CBI, see Krueger, 1993, chapter 7).

The major exceptions to these liberalising tendencies were agricultural products, including processed agricultural products, especially into the European Community; and textile and apparel products into all the major markets. The latter category continued to experience high tariffs, especially into the United States, and was subject to quota restrictions into the EC and Japan as well. In addition, procedural protection, largely in the form of threatened or actual anti-dumping suits, became common in the United States and the EC during the 1980s. For instance, 13 anti-dumping and 7 anti-subsidy cases were initiated in the United States in 1980-81; the corresponding numbers grew to 62 and 16 in 1988-89 (Krueger, 1993, p.112; also Finger, 1993).

Despite continuing restrictions on imports of textiles and apparel and a growth in procedural protection, developing countries as a group enlarged greatly their exports to the OECD countries; their share in imports of manufactured goods grew from 5 per cent in 1969 to 13 per cent in 1989. While a disproportionate share of this growth accrued to the four "Asian tigers" – Hong Kong, Singapore, Korea, and Taiwan – the rapid growth was in fact widespread, extending to other Asian and Latin American countries as well.

Further opening could occur. Hufbauer and Schott (1993, p.17), for instance, reckon that the creation of a North America Free Trade Area, combined with continued reforms in Mexico, could result in an increase in Mexican exports to the United States by about 25 per cent after five years, with little of the increase resulting from trade diversion from other developing countries.

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Protectionist pressures evoke greater public sympathy when unemployment is high or rising, i.e., when an economy is running below potential. But experience in the United States suggests that protectionist pressures are highest, not when unemployment is highest (i.e. during recessions), but rather when the dollar is overvalued, i.e., when US exports are meeting greater competitive pressure in overseas markets, and import competition is exceptionally stiff. Such was the case, for instance, in the late 1960s and again in the mid-1980s (see Destler (1992)).

Resource transfers

The industrialised countries serve not only as markets for developing countries, but also as sources of ideas, practical knowledge, and capital. Table 2 indicates net resource flows to developing countries over the period

Table 2 Total Net Resource Flows to Developing Countries

	ODA	OOF	Private	Total	ODA	OOF	Private	Total
1970-1990		Current $ Billion				At 1989 Prices and Exchange Rates		
1970	8.2	1.0	7.0	20.0	33.2	4.0	28.3	80.9
1971	9.1	1.2	6.9	21.9	34.1	4.5	25.9	82.1
1972	9.8	1.4	9.6	24.2	32.7	4.7	32.0	80.7
1973	12.7	2.3	15.0	33.9	36.3	6.6	42.9	96.9
1974	16.5	2.6	12.2	37.5	43.1	6.8	31.8	97.9
1975	21.0	3.3	23.8	56.6	47.0	7.4	53.3	126.8
1976	20.3	3.3	22.2	56.6	44.3	7.2	48.4	123.4
1977	21.0	3.3	28.8	67.0	41.9	6.6	57.4	133.6
1978	34.0	5.4	46.8	106.0	57.6	9.2	79.4	179.7
1979	31.7	5.7	53.9	104.1	48.5	8.7	82.5	159.3
1980	37.5	8.0	66.0	128.4	52.4	11.2	92.3	179.5
1981	37.2	9.2	74.3	139.1	54.6	13.5	109.0	204.0
1982	33.8	10.3	58.2	116.0	51.2	15.6	88.1	175.6
1983	33.9	8.5	47.8	94.8	51.7	13.0	72.8	144.4
1984	34.8	12.7	31.7	85.4	54.5	19.9	49.6	133.7
1985	37.0	11.6	30.5	83.1	57.4	18.0	47.3	128.8
1986	43.9	11.9	26.7	81.8	54.0	14.6	32.9	100.6
1987	48.2	13.3	33.7	92.6	51.1	14.1	35.7	98.2
1988	51.4	14.1	43.8	107.2	50.7	13.9	43.2	105.8
1989	52.9	12.6	48.3	123.3	52.9	12.6	48.3	123.3
1990	62.6	16.2	60.8	144.2	55.9	14.5	54.3	128.9

Note: Totals include net increase in short-term export credits, not included in components.
Source: OECD

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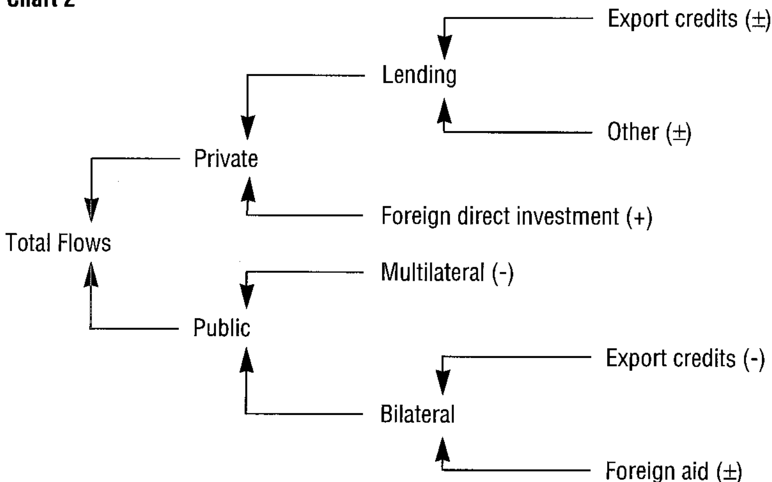
1970-1990, broken down by official development assistance (including that from multilateral development banks), other official financing (such as over one-year export credits), and total flows from private sources. There it can be seen that private net capital flows peaked at $74 billion in 1981. Total flows reached and exceeded their 1981 peak by 1990, at $144 billion. The eighties were an inflationary decade, however, and in real terms the 1990 flows were still less than two-thirds what they had been in the extraordinary year of 1981; but they had reached again the levels of the mid-1970s, and at no time during the 1980s did they drop below the level of 1974 or earlier.

How do capital flows depend on macroeconomic developments in the industrialised countries? That is not at all clear, partly because capital flows involve a wide variety of motivations. Chart 2 identifies the main kinds of capital flows to developing countries, and suggests hypotheses about whether such capital flows in general are encouraged (+) or discouraged (-) by vigorous economic activity in the sending countries.

Economists have emphasised the importance of the interest rate, but that is in fact only one factor that influences total capital flows, and perhaps not the most important one. It is true, however, that the surge of private lending in the late 1970s was associated with negative short-term interest rates, thus encouraging those that were creditworthy to borrow (see Little et al., chap.3). A boom in industrial countries will raise interest rates, on that account discouraging such lending. On the other hand, under boom conditions developing countries are more likely to be seen as creditworthy, thus encouraging such lending.

Chart 2



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Thus there is an ambiguous effect. Similarly with private export credits: higher interest rates and strong home demand will discourage them, but positive spill-over effects to the developing countries will increase both demand for exports and apparent creditworthiness of the borrowers.

Foreign direct investment, in contrast, is quite clearly positively related to strong business activity at home, among other factors. Corporations are more likely to take on new ventures at home or abroad when they have high profits and a strong cash flow. Thus it is not surprising that American direct investment abroad diminished in the mid-eighties, while Japanese investment surged; or that Japanese investment diminished significantly in the early 1990s. Foreign direct investment in developing countries rose from around $10 billion a year in the mid-1970s to $25 billion by 1990, but that represented only a small increase in real terms.

With respect to public capital flows, which in the late 1980s made up over half the total, a distinction also has to be made according to form and motivation for capital flows. Under booming conditions in industrialised countries that spill over into developing countries, demand for non-concessional loans from multilateral development banks, particularly if they carry policy conditions, is likely to be lower than during periods of economic slack. (Concessional loans and grants are always in demand, but are limited in availability.) Similarly, demand for official export credits, both by importers and by exporters, is likely to be lower under buoyant economic conditions than under slack ones, except for those products, such as large civil aircraft, that are sold only with official export credits or guarantees.

The influence of macroeconomic conditions on bilateral aid flows, in contrast, is somewhat ambiguous. These are made largely from appropriated funds, so are dependent among other things on budgetary conditions in the aid donors. With strong macroeconomic performance these are likely to be more relaxed, due to high revenues, than they are during periods of economic slack, when revenues are low and pressures will be exerted for spending more on domestic activities. On the other hand, the apparent need for economic assistance to developing countries will also be greater during periods of economic slack, and tied aid (export credits in disguise) will be a tempting way to help developing countries and domestic producers at the same time. Of course, much bilateral aid is largely dominated by political factors that are less sensitive to macroeconomic developments, e.g. US aid to Israel and Egypt.

II. WHAT ROLE FOR BETTER MANAGEMENT?

The discussion above has focused on the relationship of the OECD or G-7 economies to the economic well-being of developing countries, via demand

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for their products, interest rates on their external debt, openness of their markets, and transfers of resources. What role can closer cooperation among the industrialised countries play in enhancing the positive impact on developing countries?

Macroeconomic policies

I have suggested that a G-7 operating at full potential GDP would have helped the developing countries on balance, although individual indebted countries whose exports are not sensitive to aggregate demand in the industrial countries might have been made worse off, via higher interest rates. Even here, however, it is necessary to be clear how we define "country" – are we focusing on all the residents, or merely (as in practice) on the indebtedness of the government? – and to define indebtedness net of all external claims of the "country" thus defined.[8]

We may now ask, what contribution would better *coordination* among the G-7 have made to this process? Or to put it another way, were the national actions that were actually taken markedly different from what they would have been under an arrangement that provided when necessary for close coordination of economic policies? We will turn in a moment to the historical answer to this question, but it is worth first addressing why uncoordinated national actions might differ systematically from coordinated ones.

We may suppose that national governments, in their roles as managers of the national economy, are concerned with output relative to capacity, unemployment, inflation, the current account and external borrowing, the international terms of trade (which influences the standard of living that can be attained from a given level of output), and the budget deficit and outstanding government debt. It is well-known that where countries have similar objectives and similar (correct) views of how their economies work, coordinated action can often improve upon a non-cooperative pursuit of national objectives.[9] Governments in open economies may be reluctant to act alone to stimulate their economies out of fear of worsening their current account positions, for instance, whereas collective action will attenuate this

8 During the height of the debt crisis Venezuelan residents were estimated to have had external assets in excess of their government's external debt, and nearly as great in the case of Argentina. The World Bank has estimated private Mexican assets abroad at over $41 billion at the end of 1987, nearly half the public long-term external debt. See "World Debt Tables 1991-92", vol. 1, p. 44.

9 See Oudiz-Sachs (1984), Cooper (1985), and various chapters in Buiter-Marston (1985). Frankel-Rockett (1988) shows that coordinated action may *not* improve on uncoordinated action when one or both of two national authorities have an incorrect model of how their economies work.

problem. Similarly, two or more countries attempting independently to reduce their rates of inflation in a regime of floating exchange rates will generally pursue fiscal policies that are too expansionary and monetary policies that are too contractionary in the interests of reducing inflation at minimum cost to output; but their actions will offset one another to some extent, preventing each from gaining the anti-inflation advantage of an appreciated currency, leaving them with higher interest rates and more inflation (or lower output) than they need have if they pursued a cooperative strategy. This particular example is of special relevance to heavily indebted developing countries, since a world of higher-than-necessary interest rates leaves them worse off than they would be under a cooperative strategy (by the same token, however, it improves the condition of the creditors, *perhaps* but not necessarily overcoming the losses associated with failure to coordinate).

During the early 1980s the major industrial countries were attempting to reduce inflation substantially, under conditions of floating exchange rates.[10] As we have seen, economic activity was exceptionally low during most of the 1980s, and that cost developing countries, on the rough calculation made above, about five per cent of their exports. If the economies had been run at full potential, inflation almost certainly would not have come down so rapidly, although real interest rates (relevant to heavily indebted countries) would not necessarily have been higher than they were.

An alternative scenario would have left output on the path it actually attained (with the resulting downward pressure on rates of inflation), but would have altered the monetary-fiscal mix of policies within and between major countries, in a way that would have led to lower short-term interest rates. In particular, this would have required less US fiscal stimulus, more European and Japanese fiscal stimulus, and a modestly easier monetary policy in all regions. Under these circumstances, the US dollar would not have appreciated against the yen and the mark as much as it actually did during the early 1980s under the strongly divergent movements in fiscal policy that prevailed, and dollar interest rates would have been lower. On both counts, heavily indebted developing countries would have been better off, since most debt was denominated in US dollars, and most commodity markets operate in dollars.

A 100 basis point reduction in short-term interest rates, for example, would have reduced interest due on outstanding variable interest rate loans to developing countries in 1985 by $4.0 billion, and interest payments on all outstanding non-concessional loans by $6.3 billion (assuming those would

10 Except among France, Germany, and Italy among the G-7, all of whom were members of the European exchange rate mechanism of quasi-fixed exchange rates created in 1979. Even so, Italy had an exceptionally wide (12 per cent) band of allowable variation, and central rates within the ERM were in fact changed roughly annually until 1987.

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have carried lower interest rates from earlier years). Interest rates on short-term credits would have been $1.3 billion lower, roughly offset by $1.6 billion lower earnings on foreign exchange reserves. For comparison, total interest payments by developing countries in 1985 were $65.5 billion (excluding $2.9 billion in payments to the IMF), and interest arrears were $7.8 billion.[11]

To ascertain the net effect of a change in the policy mix confidently requires a general equilibrium model adequately structured to address this problem, focusing on the impact on developing countries. McKibbin-Sachs (1991) simulate a major dis-inflation by the industrial countries under cooperative and non-cooperative arrangements, but their inflation-reduction targets are arbitrary rather than historical. Moreover, their model treats developing countries only in a cursory way, and contains high short-term substitutability between raw material inputs and capital and labour in the industrialised countries, making their induced demand for oil and raw materials (the sole exports of two groups of developing countries) highly sensitive to the relative price of raw materials, and hence to the dollar exchange rate.[12] For what it is worth, however, McKibbin-Sachs (1991, p. 182) show a substantial first-year gain to developing countries in a notional coordinated dis-inflation starting in 1986, equivalent to about $31 billion, or roughly 10 per cent of their exports in that year, compared with a non-coordinated dis-inflation. This gain derives solely from interest savings on external debt, as the trade balance of non-oil developing countries is actually worse in the first year under policy coordination, and the terms of trade substantially worse (pp. 184-85), for the reasons already mentioned and because total output in the industrialised countries falls substantially. And of course this gain from lower interest rates by externally indebted countries comes at the expense of creditors.

In the early North-South model developed by Muscatelli and Vines (1989) a fiscal expansion in the North implies a *worsening* of the South's terms of trade, as well as a rise in interest rates, hurting developing countries on both counts.[13]

11 All calculated from data reported in the World Bank, "World Debt Tables, 1990-91", vol. 1, pp. 126-128.

12 Such that, for example, a fiscal expansion in the United States, which raises output in all industrial countries by varying amounts, actually leads to a *reduction* in demand for oil and other raw materials and a consequential worsening of developing countries' terms of trade, even in the first year of impact, as dollar appreciation leads Europeans and Japanese to substitute capital and labour for raw materials in their production. This result is highly implausible.

13 Alogoskoufis and Varangis (1992) find that fiscal deficits in the G-5 worsen the terms of trade of developing countries, presumably on grounds that high interest rates affect directly the prices of primary commodities. But their empirical work is marred by the failure to allow for the fact that fiscal deficits normally rise in recessions, due to shortfalls of revenue, and that is when demand for many primary products is also weak, thus producing a negative but spurious correlation between the two.

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The first result is the opposite of the one usually found, and found in the North-South context by Masson and Helliwell (1990) using the IMF's global model Multimod. Muscatelli and Vines (p.399) themselves express considerable doubt whether a fiscal contraction in the industrial countries would really leave developing countries better off. More recently, Allen and Vines (1993) argue against fiscal contraction by the Clinton administration on grounds that it will create a recession in developing countries as well as in the United States, unless it is clearly accompanied by a substantial dose of monetary easing.

Even if macroeconomic policy coordination might have benefitted developing countries during several past episodes, and particularly during the 1980s, we must ask whether it was feasible and, if so, why it did not take place. In my judgment, it was not feasible. Policymakers' disagreements on how their economies functioned were simply too great to make close macroeconomic coordination feasible except during temporary convergence of perceived interests [and shared outcomes]. Academic economists also continue to show substantial disagreement on the way they conceive economies as working, resulting in the substantial differences in view alluded to above (see Cooper in Bryant et al.(1988)). With respect to policymakers, one has only to recall Mrs. Thatcher's strongly monetarist views of what was best for the British economy; Ronald Reagan's supply side views about the American economy, and the continuing disagreements over the long-run consequences of the resulting accumulation of US public debt; the German fiscal and monetary panic of early 1981; Francois Mitterrand's historical mission for the French economy until he reversed course sharply in 1983; and the urgency with which Helmut Kohl's government seized the opportunity to unify Germany, heedless to the fiscal implications. Such strong-headed even if possibly wrong-headed views by national leaders about appropriate or acceptable macroeconomic policies are not going to be put under international control, and it is misguidedly optimistic to suppose that they can be in the near future. Rather, the international system should be designed to be robust to occasional misguided policies or other disruptive action by major countries.

There is the further problem that skillful macroeconomic management involves both monetary and fiscal policies, and that for two important players – the United States and Germany – monetary policy is not under the control of the national government. Under the Maastricht Treaty, all EC countries must also make their central banks independent of sitting governments, and France has announced its intention to move in this direction soon. Thus national governments, in attempting to coordinate their policies, will be unable to commit their central banks (except via commitments to exchange rate arrangements), but can only model their reaction functions, much as they do for the private sector.

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Where G-7 coordination clearly has played an important role, and can continue to do so in the future, concerns management of the international trading system, contributions to multilateral lending institutions, and international debt relief.

Trade policies

The achievements of the Kennedy and Tokyo Rounds of trade negotiations have already been mentioned. In 1986 nearly 100 countries launched yet another round of trade negotiations, called the Uruguay Round, more ambitious in scope than any previous round. It was still not completed by mid-1993. It aims not only to reduce tariffs further, and to eliminate them where they are already very low, but more importantly to extend the general framework of the General Agreement on Tariffs and Trade (GATT), which covers only merchandise trade, to international trade in services, to trade-related international investment, and to protection of intellectual property. A major effort is also being made to reduce policy distortions to international trade in agricultural products and international trade in textile products.

By 1993 more than 100 countries were directly involved in these negotiations, and it has proven difficult to put together and sustain a package of agreements that appeals to all. Of special interest to developing countries in the emerging agreement is a major assault on the existing rather restrictive regime on international trade in textiles and apparel, the Multifiber Agreement (MFA), in the direction of liberalisation and ultimately phasing it out in favour of tariff protection only. Also of interest to some developing countries will be the restraint on subsidies to agricultural production and export by industrial nations, although of course some food-importing developing countries benefit from subsidised exports of agricultural products.

The major rounds of trade liberalisation could not have been achieved without intense negotiation and ultimate agreement among the major industrialised nations, mainly the United States and the European Community (where European negotiating authority has resided for its members since 1958), the two largest markets. The Uruguay Round was needlessly delayed and consequentially put in jeopardy by a radical (although intellectually defensible) proposal put forward in 1987 by the United States to eliminate by the year 2000 all subsidies to agricultural production (although subsidies to *farmers* could be maintained social reasons), and the response by the European Community to ridicule the US proposal in lieu of taking the issue of agriculture seriously. It was dislodged from this obstacle only in November 1992, by which time the negotiating authority of the US President had almost expired. President Clinton has requested a renewal of that authority from the US Congress, but it remains to be seen what price he must

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pay for the renewal, and in particular whether it will require the effective exclusion of textiles and apparel from the Round. If so, this will represent a major failure of cooperation by the United States and the European Community at the expense of developing countries.

Resource transfers

Another area where cooperation among major industrial countries has been highly successful in the past, but has faltered from time to time, is in creating and promoting the multilateral development banks and the International Monetary Fund. The IMF and the International Bank for Reconstruction and Development (IBRD, now, with the addition of the IDA and IFC, called the World Bank) were created in 1946; since then an Inter-American Development Bank, an Asia Development Bank, an African Development Bank, and most recently a European Bank for Reconstruction and Development have been added to the family of multilateral development banks. A Global Environmental Fund (GEF) is being added to the responsibilities of the World Bank.

Each of these institutions required intense negotiation to establish, periodic replenishment of capital subscriptions plus appropriations for their soft loan affiliates, and continual guidance on lending policies and practices. Each has had its foibles and its controversies. But on the whole these institutions represent outstanding examples of international cooperation and collective management. By 1990, for instance, new lending by the World Bank reached $13.6 billion ($18 billion counting highly concessional IDA loans), and total outstanding World Bank loans were $141 billion (of which $45 billion were IDA loans). Outstanding loans by all multilateral development banks and their affiliates reached $209 billion.[14] Outstanding IMF credits came to $35 billion. And although they are sometimes resented, the policy conditions that attend many of these loans on the whole have been helpful both to economic stabilisation and to development.

Subscriptions to the multilateral development banks and their affiliates, and increases in IMF quotas (the most recent of which occurred in 1991-92), represent a form of explicit international burden-sharing, as do subscriptions to the United Nations and other international organisations. The G-7 undertake the bulk of the payments, accounting for nearly two-thirds in the

14 For comparison, total outstanding bilateral official long-term loans to developing (including eastern European) countries were $316 billion, of which $176 billion were concessional; total outstanding private long-term public and publicly guaranteed loans amounted to $458 billion, of which $228 billion were from commercial banks. See World Bank, "World Debt Tables 1991-92", volume 1, p. 120.

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United Nations and over two-thirds in the World Bank. Joint financing of commonly-shared objectives represents a high degree of international collaboration. Such burden-sharing has been much less successful in the case of bilateral aid, which tends to be driven more by domestic political and national foreign policy considerations. Periodic attempts to set internationally agreed targets for bilateral aid have generally had little effect, although they may have played some role in aid-giving by smaller donor countries.[15]

A related area of international cooperation, which started in the 1960s but became especially important during the 1980s, concerns debt rescheduling. Here, to be effective, the majority of creditors must participate; and if they are to participate, they want to be sure both that they participate on broadly equivalent terms (so some creditors are not favoured at the expense of others) and that the results of their collective efforts will be positive for the debtor country. The Paris Club conventions for rescheduling official debt go back to the mid-1960s, but have been gradually relaxed in response to the needs of the 1980s, most dramatically (at the 1988 Toronto G-7 Summit) for the least developed countries, then (at the 1990 Houston Summit) for lower middle-income countries.

Such rescheduling takes place in the framework of a macroeconomic plan for the debtor which has been worked out with the assistance of the IMF – or a surrogate, on those few instances in which the IMF could not participate (e.g. Poland was not a member in the early 1980s). This collaboration became almost routine in the 1980s; in 1985 a peak of 21 reschedulings took place under Paris Club auspices, and 18 occurred in 1990. A peak of $24 billion was rescheduled in 1987, not counting the exceptional comprehensive reschedulings for Egypt and Poland in 1991.

A roughly comparable process, called the London Club, came to be established for rescheduling debts to commercial banks. Governments of industrial countries have been less directly involved in this process. But in the early 1980s, following the Mexican debt crisis of 1982, the IMF came to require agreement of a debtor with its creditor banks as a condition for an IMF-approved program, thus unwittingly strengthening the hands of the banks at London Club negotiations.[16] This practice was explicitly dropped following US Secretary of Treasury Nicholas Brady's call in early 1989 for

15 In the 1970s the United Nations adopted a target for total foreign aid (including contributions to multilateral development institutions) of 0.7 per cent of GDP for each donor nation. While this target is periodically repeated in UN resolutions, the United States has never formally accepted it.

16 Agreement with creditor banks was thought to be required to complete the prospective balance of payments analysis for each country, a key analytical input for IMF programs.

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debt relief by banks. Subsequently, a framework was worked out (first in the case of Mexico) for providing banks with several options for converting their outstanding claims, each of which involved some concessions to the debtor country. While the schemes were technically voluntary, the moral and financial support (mainly through multilateral institutions) by the G-7 governments created a context in which refusal to play would have been difficult for the banks, thus minimising the omni-present problem of free riders.[17] So in the end the G-7 governments played a critical role in easing the debt burden on developing countries. But they did so much later than would have been desirable.

III. OTHER AREAS FOR POTENTIAL COOPERATION

Other obvious areas requiring cooperation among the major industrial countries concern the rules (if any) for managing exchange rates among major currencies, and such collective decisions as issuance of SDRs. These will be covered by Kenen's paper. Less obvious in a conference of macroeconomists is management of global resources such as open-water fisheries and the atmosphere, and access to non-national territory such as the seabed and Antarctica. Such areas have not been ignored by the international community, but the record of good management is slim, and in some domains major mistakes have been made.

In the mid-1970s an allocation of one quarter of the earth's surface occurred, in the form of the 200-mile coastal exclusive economic zones, an allocation that far exceeded the maximum acquisitions of territory by Nazi Germany and Imperial Japan in late 1942. The major beneficiaries were the rich countries, with their long coast lines. Ironically, this international allocation was initiated and urged by certain developing countries (first in Latin America), although of course they found ready allies within the rich countries, especially among fishermen and all those distrustful of international cooperation. The developing coastal states hoodwinked their landlocked and other geographically disadvantaged colleagues in the G-77 into supporting their position favouring coastal state acquisition, under the name of G-77 solidarity, in opposition to some form of management that assured that at least the rents from international fisheries management and continental shelf oil exploitation beyond territorial waters would be used for

17 Unlike under the so-called Baker Plan of 1985, which called on major commercial banks to lend more to developing countries, but created no framework which made this attractive to individual banks. For a discussion of the debt question, see Cohen (1992), Cooper (1992), Krueger (1993), and Sachs in Feldstein (1988).

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internationally agreed purposes, presumably including foreign assistance, as proposed by the US (Nixon) Administration in 1969.[18]

The deep seabed was established as a "common heritage of mankind" in the Law of the Sea Treaty of 1981. But the United States declined to sign the treaty, not over that principle, but over the insistence by developing countries that an international public Enterprise actually *engage* in exploitation of the deep seabed, that private enterprise transfer proprietary technology to said Enterprise, and that dispute settlement occur in an international tribunal with a bias favouring the Enterprise. In the event, no exploitation of the seabed has taken place, despite high promise in the late 1970s, although weak mineral prices probably played a greater role than disagreement over the international regime in ensuring the non-development of this resource.

The international regimes for managing living resources outside the 200-mile zones, mainly marine mammals and tuna, have continued to be a source of controversy; Norway recently renounced the International Whaling Agreement, and Japan may soon do so, after six years of moratorium on whaling.

Happier (so far) is the regime that has been established to phase out the production and use of chlorofluorocarbons (CFCs), which have been determined to destroy high-stratospheric ozone, which is essential for absorbing solar ultraviolet radiation. In a remarkably short time, once the evidence of ozone destruction was confirmed, an international agreement was reached to phase out production, with special allowance for developing countries on timing but not on principle.[19] The free rider problem is manifest in this area, and close international collaboration was necessary to reach agreement, which was made easier by the development of not-too-costly substitutes for CFCs in most of their uses.

A comparable issue, but one of infinitely greater complexity, may arise with the possibility of global climate change resulting from anthropogenic emissions of so-called greenhouse gases, substances that absorb energy at the wavelength of the earth's radiation, thus heating the atmosphere. Quantitatively the most important gas (apart from water vapour) is carbon dioxide, a waste product of oxidation, especially of hydro-carbon fuels, of which modern economies use a great deal. This issue will tax greatly the cooperative powers of the major industrial countries, not least because full

18 India denounced the proposal as a scheme to extend the global reach of the major oil firms, even though oil development would have been under coastal state supervision, with royalties going to the international community. Such was the distrust among nations that a major opportunity was missed. See Cooper in Bhagwati (1977).

19 For a description of the international negotiations in the late 1980s, see Benedick (1991).

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solution requires also the active cooperation of many other countries, especially Russia, China and India; but detailed consideration of this potentially important topic is beyond the scope of this paper.[20]

IV. CONCLUSIONS

International cooperation among major industrialised countries has not been lacking during the past four decades. It has registered some notable achievements, but it has also registered a number of deficiencies. These deficiencies have not occurred, in general, because of lack of recognition of the problem by analysts, or because of a lack of willingness by governments to cooperate with others (although the United States experienced this anti-cooperative attitude briefly during the first Reagan Administration), but rather because the problems are difficult, there are substantial differences of diagnosis, there are substantial disagreements on remedies, and (under these general circumstances) there is substantial domestic political opposition to taking costly measures without clear, generally agreed, and well-distributed benefits.

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20 For a preliminary view, see Cooper in Hurrell and Kingsbury (1992). Also Cline (1992).

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Comment on "G-7 Economic Coordination and Developing Countries," by Richard Cooper

Niels Thygesen

Richard Cooper has at least three qualifications for addressing the theme of his paper: He was a pioneer in research on international macroeconomic interdependence with his major theoretical and empirical study 25 years ago and he has continued to be a leader in this, now more fashionable, area. As Under Secretary of State to the Carter Administration and in numerous other public offices he has an unusually rich experience in actual efforts at policy coordination. Finally, he is an idealist, not afraid of radical ideas, as his reform proposals for the international monetary system show – stretching all the way, eventually, to a single currency for the industrial democracies.

In the present highly competent and comprehensive survey Cooper draws primarily on his first two qualities. The bulk of the paper is a hard-heated evaluation, based on the best parts of the available empirical literature, of the deficiencies of economic management in the G-7 countries in the 1980s and of the scope for improved performance due to better international macroeconomic policy coordination. The rest of the paper contains insightful comments on two other areas in which policy changes in the G-7 countries would have been helpful to the economic prospects of the developing countries: market access in the industrial countries and larger official and private transfers to the developing countries. The record of the industrial countries is not altogether poor in these other areas, though Cooper finds much to criticise. He also points out, no doubt correctly, that there would have been a positive interaction between better macroeconomic performance in the G-7 countries in the 1980s, and the readiness of these countries to pursue liberal market access policies and maintain higher levels of transfers to developing countries. This makes it natural, also for a discussant, to concentrate on the inadequate, or at least highly uneven, macroeconomic performance of the G-7 countries.

In doing so, I note primarily some points where I would have put the emphasis differently from Cooper. By focusing on the 1981-87 period during which G-7 GDP fell consistently short of potential output and disregarding the final years of the decade when output tended to exceed potential, the back-of-the-envelope estimates in the paper tend to exaggerate the benefits in

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the form of the larger export earnings (US$ 15-45 billion annually) which would have occurred to developing countries in a longer-run perspective. This is true, even if one accepts the somewhat optimistic assumptions of Cooper's calculation, notably that inflation, nominal interest rates and energy prices had remained on the downward course generally observed in the 1981-87 period. The author does question these assumptions in an appropriately critical way, leaving the impression that he too regards the increase in exports from developing countries as an upper bound to what might have been feasible in the 1981-87 period, but he does not say that there was a compensating temporary gain for the developing countries in the 1988-90 period when the G-7 economies were in the aggregate operating at levels in excess of their long-run potential. The fairly cautious macroeconomic policies pursued in the earlier period – with the US budgetary stance as the main exception – ultimately paved the way for the strong boom at the end of the decade. Both periods have to be evaluated jointly.

Implicitly, by not analysing the performance of the G-7 economies in 1988-90, Cooper appears to approve of economic management in this more recent period. Yet it was here, I would argue, that the record in at least some of the central countries became ominous both from the perspective of the industrial countries themselves and from that of the developing countries which depend on exports to the OECD area. By allowing their economies to become overheated and overburdened with debt, the United States, the United Kingdom and Germany in particular, stored up, or failed to correct, imbalances in their economies which have dragged the whole OECD area into a deep and prolonged recession in the first half of the 1990s. Failures of economic management showed up at different times in individual countries: the United Kingdom allowed a strong credit-financed consumer boom to develop from 1988, the United States failed to reduce her Federal budget deficit in the good years – while both endangered the stability of their financial systems – and Germany chose, or drifted into, a policy-mix which relied excessively on borrowing to finance the costs of unification, requiring high interest rates to contain inflationary pressures long into the subsequent recession. Policy mistakes were even more obvious in some smaller European economies, such as Finland and Sweden, where boom conditions marked by over-full employment and rising inflation were allowed to develop. In Japan, the efforts to soften the pricking of a major bubble in asset prices triggered initially excessive weakness of the currency and a prolonged need for subsequent adjustment.

As a result of the policies of the 1988-90 most of the G-7 economies have since found themselves trapped in a down-turn of unexpected severity and duration. Some of the mistakes may have been triggered by, in retrospect, excessive fears of the impact of the stock market crash of October 1987,

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others by exogenous events, such as German reunification. Whatever the original inspiration, the consequences are extremely serious and damaging also to others in the world economy. Cooper might therefore have been more critical and more topical in his evaluation of G-7 countries if he had focused on a later period than 1981-87 which now appears a relatively successful experience. After all, some loss of output was unavoidable following the 1979-80 oil price hike, and high priority had to be given to bringing inflation down from the double-digit level reached in many industrial countries. This time round there are fewer excuses for inadequate performance. Even the failures of policy coordination are less obvious than they were in the early 1980s (for which Cooper offers a vivid summary).

Could better coordination among the G-7 countries have improved macroeconomic performance in a major way then – and can it do so now? I share Cooper's scepticism that anything significantly could have been achieved in the first half of the 1980s when economic policies diverged widely and while divergence in economic philosophies appeared to be at a peak. Now both the economic fundamentals and strategies seem closer to one another. The sad, even dramatic, fact is, however, that the freedom of action which may have existed in some earlier phases of unsatisfactory performance, including 1981-87, has disappeared, because it has been absorbed by earlier imprudent policies in the budgetary area. In OECD Europe public sector deficits have risen to historical peaks as a result of the legacy of large structural deficits from the 1980s and the weakness of demand which prevails almost everywhere. To propose a stimulus through tax cuts and/or larger public expenditures seems counterproductive in the present context, since it could prevent some further decline in long-term interest rates which remains desirable. In the United States and Japan public finances have also been stretched to the limit – and so has the capacity to lower short-term interest rates. The Clinton Administration and any European government are currently faced with the next to impossible task of assuring longer-term budgetary consolidation in a situation where the public debate is naturally more concerned with overcoming the present recession.

In the European Community which is the region most seriously affected by the current recession – and the most heavily marked by structural deficiencies in the functioning of their labour markets – the emphasis in the policy debate shifted in the course of the 1980s from coordination of economic policies outside the monetary area towards a longer-run strategy of leaving as much autonomy in budgetary policy as possible to individual member states, but subject to careful monitoring by the Community of strongly deviant behaviour with respect to deficits and debt. This philosophy is embodied in the so-called convergence requirements of the Maastricht Treaty which set upper reference values for the deficit and for public debt, both expressed as

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ratios to GDP. These provisions seem to many, particularly non-EC, observers strangely out of date in an environment of low activity and employment. Departures from them as the cyclical components of deficits widened have indeed been accepted, though not openly advocated. Yet in looking back on our experience during the 1980s, something like rules of the Maastricht type would have served most European countries, as well as the United States and Canada, rather well now if they had been applied vigorously in the relatively successful decade of the 1980s.

Rules to prevent strongly deviant behaviour, contain the wisdom that some freedom of action has to be preserved for when it is really required. If we had started the decade of the 1990s without structural public sector deficits, as would surely have been warranted in the OECD area while most countries were operating their economies at or above potential output, more vigorous action to contain recession would now have been possible. It is essential that, when the upswing finally comes, resources be devoted to durable budgetary consolidation. Without that no efforts at international coordination of demand management can be successful and industrial countries will be condemned to relive their own powerlessness in the face of a serious downturn.

It might be healthy, also from the perspective of the developing countries anxious to see a recovery in the G-7 economies, if the future debate on the scope for international macroeconomic policy coordination in that form would put those longer-term considerations in focus. Coordination efforts which focus more narrowly on the shorter-term issues of eliminating departures from potential output are certainly desirable, but the major purpose of coordination has to be more modest, i.e. to preserve an international regime in which the kind of cyclical instability we have seen since the early 1980s is reduced and some essential public goods are better preserved for the international economy: a free trading system, the avoidance of major currency swings which trigger a mixture of protectionist measures in some countries and efforts at competitive depreciation in others, and stable economic growth conducive to an efficient international division of labour. The record of the past decade and a half is not encouraging in these respects.

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Comment on "G-7 Economic Coordination and Developing Countries," by Richard Cooper

Kumiharu Shigehara[1]

It is always a pleasure to read a paper by Dick Cooper, and hence a double pleasure for me to be here today to act as a discussant on his paper on G-7 economic coordination and developing countries, especially with such a distinguished chairman – indeed my former boss at the OECD.

Economic cooperation and development is literally the *raison d'être* of the OECD, and has been an issue on which I have worked for much of my professional life, so I am particularly happy to be able to develop some remarks on the themes of Cooper's paper which is wide-ranging and stimulating. I think it is important that the interactions between policy coordination of developed countries and developing countries are given due weight, because we are indeed living in a very interdependent world and the developing countries are an important part of that world. It is interesting to note too, that there has been increasing recognition that global economic problems and global environmental problems, which is where the author ends his paper, are linked – as evident in the Rio Conference last year, in the very concept of sustainable development that we hear so much about now and in all discussions of development problems.

I would like to focus my remarks on three issues which have been taken up in the paper:

1. the characterisation of North-South relations,
2. the "believability" of the model results in the paper, and,
3. the politics of G-7 coordination and how G-7 and the OECD countries more generally should be helping the developing countries.

On the first issue, the characterisation of North-South relations, Dick Cooper has rightly raised the problem about the proper specification of the "South". While the "South" is indeed a convenient collective term for all developing countries, he is right to point out that it is a very disparate group of countries which have little in common apart from being poor relative to

1 Head of Economics Department, Organisation for Economic Cooperation and Development (OECD). The views expressed here are personal ones and do not necessarily represent those of the Organisation.

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most OECD countries. I would stress even more than does Cooper the importance of not analysing linkages in a traditional North/South framework – the myth of a rich industrialised "North" exporting manufactures to a poor indebted "South" and importing primary commodities from them.

The first point I would stress is that intra-OECD trade in non-oil primary products is more than twice as large as OECD imports of such commodities from non-OECD countries. On the other hand, well over half of OECD imports from non-OECD countries are of manufactured goods. Even excluding trade with the Central and Eastern European and the dynamic Asian economies, about a third of OECD imports from non-OECD countries is of manufactured goods.

"South" countries also differ considerably in their geographical trading patterns. African countries are essentially in the EC zone, Latin American countries in the North American zone and (some) Asian countries in the Japan zone. The economic cycles in the three principal "North" zones have not been in phase and this has been reflected in divergent trade and growth patterns among "South" countries belonging to different "North" zones.

Cooper points out that "South" countries vary with respect to the level and structure of external debt. In fact, the dynamic Asian economies have virtually no debt constraints, some Latin American countries still have considerable amounts of outstanding debt owed to commercial banks, and many African countries have considerable amounts of debt owed to "official" lenders. Changes in market or policy-influenced interest rates will have different effects in each case. Furthermore, much commercial bank debt, originally incurred on LIBOR terms, has been converted to long-term paper, or into equity.

This brings me to my second issue – the extent to which we should believe the model results quoted in the paper. The implication of my comments on the false North/South dichotomy is as indicated by Cooper that models based on the traditional North/South distinction may not be very useful, and more plausible results can perhaps be obtained using a more disaggregated approach, such as the World Bank's Global Economic Model which has 144 country sub-models.

Broadly speaking results from such models indicate that the impact of fiscal tightening in developed countries on a developing country depends on where the fiscal tightening originates (US, EC, Japan), and where the developing country is located (Latin America, Africa, Asia). Some of the direct impact of a contractionary fiscal shock in developed countries on developing country export volumes is alleviated by lower short- and long-term interest rates associated with fiscal tightening. Measurement of this indirect monetary impact on developing countries associated with a fiscal shock should also be based on a more disaggregated approach. Changes in interest rates in

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developed countries impacts most heavily on Latin America and Africa, with the dynamic Asian economies being hardly affected.

I have a second set of reservations, which concerns the assumptions used for generating the model results. This relates in particular to the assumptions for the G-7 or OECD countries. Is it really likely that, through better domestic policies and/or policy coordination, they could have operated their economies at potential in the 1980s while experiencing the same interest and inflation rates as actually observed? More specifically, could the European countries and Japan really have abandoned their fiscal consolidation strategy in the 1980s and have kept interest rates unchanged at baseline levels? Frankly, I doubt it. Higher inflation, which all OECD countries had had to fight hard against from the start of the 1980s, would almost certainly have involved the need for higher interest rates – as pointed out before – with effects on developing countries which would have offset much or all of the beneficial effects of higher short-term OECD growth which fiscal laxity in the European countries and Japan might have brought about.

I won't run through all the other assumptions, but it seems to me that many of them are on what one might term the "optimistic" side. Cooper has been brave in putting numbers down and giving his estimate of 5 per cent higher developing country exports in the period 1981-87 arising from stronger OECD growth, but I would suggest that this must be the absolute maximum. I strongly believe that, in this sort of replay of history, interest rates would have had to be much higher and the external conditions facing the developing countries rather worse than Cooper suggest. To be fair, he admits that the calculation is a partial analysis, that the right models do not exist, and that relaxing the assumptions would reduce the estimate. It is just that my choice of assumptions would have been less favourable to the developing countries in the first place.

Let me now turn to the third issue I would like to address, concerning the politics of G-7 coordination. Let me start with a general point. I believe the best thing that the G-7 can do for the rest of the world is to aim for a reasonable level of stable, sustained growth with low inflation. Let me stress stable and sustained. What is bad for the "South" is lack of stability in the "North", giving rise to volatility in activity, prices – especially commodity prices – and interest rates. Having higher short-term OECD growth is of little benefit to non-OECD countries if it ends in tears, as has typically happened in the past, with inflation turning up, the need for restrictive policies, higher interest rates and lower market growth.

Cooper's paper also raises the general issue of what we mean by "policy coordination" and under what conditions it is likely to succeed. In virtually all spheres of economic policy, there is some degree of policy coordination in the sense that Governments, in framing their own policies, take account of

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each other's actions and experiences. International organisations such as the OECD contribute in an important way to this process by providing Governments with a forum for the ongoing exchange of information – information about the economic context in which policy choices must be made by governments, about each other's assessment of that context, and about the actual policies adopted. As a result, contemporary governments, unlike their counterparts fifty years ago, do not take decisions largely in ignorance of what other governments are doing or intending to do. Rather, they tend to share a fairly common view of the international economic climate, and set their expectations about policy outcomes on the basis of reasonable knowledge of the goals and intentions of their peers.

But the term "policy coordination" as used in the paper goes well beyond this largely informal process of adaptation. Rather, it has strong connotations of concertation and cooperation; that is, of collective action aimed at common ends. There are, simplifying somewhat, two major ways in which this may occur, each suited to rather different circumstances.

The first is a commitment to common rules: to an agreed way of acting in specified circumstances. The multilateral trading system has been the outstanding example of such an agreement, embodied most importantly in the GATT. These rules are in the nature of a contract; and like other contracts, they are most likely to succeed when they reflect shared norms and a common understanding of the relation between means and ends. Their stability depends on the willingness of Governments to maintain commitment in the face of evolving circumstances: to not seek, in other words, to re-write the contract each time changes occur in the context for its implementation.

Secondly and in contrast, Governments may retain their discretion to act but seek to exercise it jointly: to meet changing circumstances not through the adherence to pre-established rules of conduct but rather through a process leading to concerted intervention. Such a discretionary approach has underpinned the search for agreement in the G-7.

Rules and discretion each have merits. A rule-based system gives greater predictability and is less vulnerable to the abuse of changing bargaining power: the currently strong are less well placed to exploit the currently weak. But discretion can allow greater adaptation to shifting circumstances, and can thereby avoid the types of costs which inflexible rules - for example about exchange rates – may impose.

What is an open issue is how relevant either of these approaches is to the current conduct of macroeconomic policy. Few would believe that in the current environment there is much scope for imposing fixed common rules on macroeconomic operation in the G-7. But even the options for the joint exercise of discretion by the G-7 may be severely limited. Each government

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may not know enough about where its economy actually stands in the conjuncture; it may not be able to predict with sufficient accuracy how the policies adopted will act, or how quickly their effects will be felt; and hence it may not be able or willing to forego the continued responsiveness to unforseen local circumstances. What counts under these conditions is that governments and central banks should jointly intensify that informal process of adaptation. This is exactly what the OECD Working Party No. 3 consisting of senior Treasury officials and central bankers of North America, Japan and several European countries intends to achieve at its quarterly meetings in Paris.

As regards trade policy, it is important that OECD markets are kept open to exports from developing countries, especially for manufactured goods. As Cooper notes, it is particularly disturbing that what he calls "procedural protection", such as anti-dumping suits, became common in the 1980s and seem to have been on the rise. Although developing countries have increased their shares of OECD imports of manufactured goods, further opening indeed needs to occur. But unfortunately protectionist pressures have been on the rise - despite all the fine words about completion of the Uruguay Round – and alarming sounds are being heard in OECD countries partly, of course, because of recession and the high unemployment being experienced. At the OECD Ministerial Meeting in early June, Ministers agreed to make full use of the GATT system and of the more informal mechanisms and broad expertise available in the OECD, so as to contribute to a reduction of international trade tensions and to the efficient operation of the multilateral trading system. In this context, the OECD is now working on new issues arising at the interface of trade policy and other national policies; for example the OECD Trade Committee and the Committee on Competition Law and Policy are discussing competition issues relevant in a trade perspective, such as export and import cartels, anti-dumping, vertical restraints, international mergers and other areas. The question of the desirability and feasibility of integrating competition rules into a multilateral framework will be explored.

Let me now turn to international resource flows. Cooper discusses the decline in private net capital flows in real terms and gives information on foreign direct investment, export credits and foreign aid flows. Apart from the obvious point that the "quality" of the use of these resource flows is important – they should be in uses with a satisfactory rate of return and be used to improve longer-term output prospects – I have some concern about the aggregate amount of resources available. The admittedly-imperfect figures on global and regional savings and investment seem to show that first, global savings ratios are now lower than they were in the 1960s or 1970s, and second, that the excess of savings over investment in OECD countries that characterised much of the post-war period seems to have disappeared.

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In other words the net capital flows from the North to the South seem to a certain extent to have dried up and the more mature economies are absorbing non-OECD savings to finance budget deficits and the deficiency of national savings. This is a worrying tendency. Cooper is right to call for better coordination of G-7 policies to address these issues and he is also right to point out the achievements of the multilateral financial institutions such as the IMF and the World Bank and its affiliates in organising and disbursing resources to the developing countries, as well as organising debt rescheduling and relief. Ultimately, however, I think it is necessary for the OECD countries to ensure that they get their fiscal positions right, and to coordinate their macroeconomic policies as they do this so as to avoid undershooting or overshooting and hence provide a more stable international environment. In doing this, and in ensuring that their markets are open, they do the best service to the developing countries and to global welfare.

Before closing, let me say how pleased I am that Dick has raised the issue of cooperation on global environmental problems. Such cooperation is necessary, is very important for the future of all our economies, and I am pleased to say is an area where we are doing much work at OECD in supporting the various international initiatives to deal with the problems and promote sustainable development. At their meeting in early June this year OECD Ministers asked the OECD to pursue its follow up to United Nations Conference on Environment and Development (UNCED), and in this regard to consider the feasibility of analysing the relationship between consumption and production patterns and sustainable development.

Finally, I must add that the OECD is broadening and deepening dialogue with the different groups of non-Member countries (Central and Eastern European countries, Newly Independent States of the former Soviet Union, and Dynamic non-Member Economies of Asia and Latin America) in an effort to bring about the successful integration of these economies into a multilateral system.

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Floor Discussion of the Cooper Paper

Success or failure of G-7 coordination?

Richard Cooper's statement that in the 1980s policymakers of the G-7 countries had failed to agree on macroeconomic coordination led to strong reactions from participants who either endorsed or disputed Cooper's view.

Emile van Lennep, Secretary General of the OECD from 1969-1984, was among those who disagreed with Cooper. According to van Lennep, the policies pursued by the industrialised countries had shown exactly the opposite: "a remarkable consensus".

"I can assure you that from 1981 onwards there was consensus – not disagreement – concerning the objectives of industrialised countries. The first objective was to bring down inflation, the second to move away from short-term demand management to medium-term improvement of the flexibility of the economies to make them more responsive to outside disturbances. That entirely different kind of approach was reached by consensus, and I myself was present when at a Ministerial Meeting in mid-1984 such agreement was reached. In my view there was not failure in coordination but success in coordination. From the mid-1980s onwards we agreed on the basic elements of economic policy, which still prevail. There was general agreement on the priority of bringing down inflation as a condition for sustained economic growth. The extremely high rate of inflation at that time was brought down at the cost of some economic growth and at the cost of other economic goals such as maintaining maximum imports from the developing countries. But I do think that in the longer run, the developing countries have benefitted from that approach, from that consensus."

Another view from inside was given by Mario Sarcinelli, who had been "part of this G-7 carrousel".

"Many of the discussions I had with my colleagues were to a large extent frustrating because the only message which was continuously repeated – and I am referring to the period between 1982 to 1990 – was: 'Keep your own house in order and everything will be alright', with the minor variant, 'You should concentrate on eliminating structural impediments'. From time to time there was an effort to coordinate, but there was almost no real discussion of how to do so with respect to short-term demand policies. The recollection of what had happened in Bonn in 1978 was still fresh in the memory, and our German colleagues reminded us time and again what the consequences had been for Germany. In my view, the best contribution made by the G-7 was troubleshooting, crisis management."

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John Williamson also believed that G-7 had failed to improve its policy coordination in the 1980s. "We had the Reagan Administration pursuing a quite irresponsible fiscal policy, creating problems which are still there to this day. We had Margaret Thatcher who overvalued the pound to the point where something like a quarter of the manufacturing industry was wiped out in the recession. We had Mitterrand, who, as Dick Cooper has illustrated, spent five years essentially eliminating the problems he had created when he became president. The question, however, is not whether one could have expected the representatives of these three governments to sit down and jointly agree, in a *discretional* manner, on better policies, but whether one could have established better *rules* that might have headed off some of the problems."

Ricardo Ffrench-Davis also felt that G-7 coordination had not been optimal during the 1980s and early 1990s. Although he agreed that bringing down the rate of inflation was of crucial importance, he thought the policy had failed on two accounts: the resumption of growth, and the provision of better price signals for the allocation of resources.

"Since we are discussing G-7 coordination and LDCs, it is interesting to note the signals received by LDCs. I think that the signals for LDCs were even more misleading than those for developed economies. The interest rates faced by LDCs were more unstable than those prevailing in the US domestic market, in the German domestic market, or in the Japanese domestic market. International prices were also very unstable; the average rate of inflation was lower but prices changed a lot and this had a great impact on countries that were exporting. In Latin America, for example, exports were 20 per cent of GDP – if we exclude Brazil, we even have a figure of something like 25 per cent – as opposed to economies like the U.S., that exported on average in the 1980s only 8 per cent of GDP, or Japan, which exported 12 to 13 per cent of GDP. Interest rates, exchange rates and relative prices were providing very confusing and misleading signals for the allocation of resources in countries that were implementing structural reform programmes, at a time when it was even more necessary to get accurate signals. In that sense I would say that G-7 macroeconomic coordination has performed rather badly during the 1980s and early 1990s."

Percy Mistry added that he was "uncomfortable" with the fact that it seemed almost normal to discuss a system of cooperation and coordination in which 80 per cent of the world's population, and 70 per cent of its surface area were literally dismissed "as a footnote".

Looking to the future

John Langmore saw hope for the 1990s, because his impression was that there is now some scepticism concerning the 1980s ideologies, "which were

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preoccupied with inflation, kept a tight monetary policy and led to high interest rates, which was of course very damaging to developing countries as well as to the level of activity in industrialised countries." He argued that since inflation is now much lower and unemployment much higher, it is likely that electoral pressure in industrialised countries will emerge to give greater attention to the stimulation of growth and employment. "This may also lead to a better balance in the use of monetary and fiscal policies in the G-7 countries, or in Western countries generally," Langmore said with a tone of optimism.

Helen Junz, referring to John Williamson's earlier remark about the use of balance of payments targets as a way of helping prevent the export of jobs from industrial to developing countries, was pessimistic about the ability of industrialised countries to combat unemployment.

"Regarding the job export question we are basically talking about the inability of industrialised countries, particularly the European countries, to create jobs. OECD studies tell us that over the past 15 years very few new jobs have been created. This has very little to do with the fact that jobs have been exported but everything to do with the fact that the structural adjustment one has talked about for so many years has just not taken place because it has been impossible to confront vested interests."

Philippe Moutot, agreeing with Cooper's emphasis on trade liberalisation, warned that free trade would be threatened by the lack of monetary cooperation. "Lack of monetary cooperation means instability in terms of exchange rates. And when exchange rates are unstable, politicians are more difficult to convince that trade should be further liberalised. That is something that has to be taken into account."

Following up on the goal of stable exchange rates, Peter Kenen asked Cooper – who has advocated the introduction of a single currency and a single central bank for the industrialised countries in the first decades of the next century – which method he would recommend in order to achieve this ideal. "Do we get there – and that is analogous to the debate now going on in Europe – by the gradual tightening of exchange rate management and the movement to total monetary union, or should we float until the day exchange rates are fixed?"

Cooper's reply

Cooper did not think Emile van Lennep's point about G-7 consensus on policy objectives contradicted the argument he had put forward in his paper.

"My comment on G-7 coordination was not directed at objectives, because at the general level there is usually consensus on objectives: we are all in favour of full employment, sustained growth and low inflation. The question

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is what happens when you try to operationalise those objectives. My shorthand version of the early 1980s is that, from a cosmic point of view, it was a very badly managed period."

According to Cooper, in the early 1980s both academics and officials had "radically misjudged" the consequences of the anti-inflationary policies that were adopted. "There was disarray, both in the academic and the official world, about how the world actually worked. My own view is that there was a serious failure of coordination of policy in the early 1980s."

Turning to the present, Cooper reacted to the question of whether one should worry about large surpluses and deficits, particularly the Japanese surplus and the American deficit?

"Now we have a functioning world capital market I think we can be – I mean we in the industrialised countries – much more relaxed about large imbalances in current account positions, provided – and that is a critical premise – they reflect genuine and public preferences and not fiscal policies that are screwed up. The problem at the moment is that Japan has a much too tight fiscal policy – which contributes to the large Japanese current account surplus – and that the U.S. still has a much too easy fiscal policy."

Talking about the near future, Cooper said he would be quite positive about a substantial SDR allocation. "The SDR has unhappily become a kind of stepchild of the international system. The international community is on record as wanting to make the SDR the centrepiece of the international monetary system. It is still very far from that, at least in the short-run. But I think we have to keep SDRs alive, and keeping them alive means making allocations from time to time – once in a decade or so is not too often."

Cooper heartily endorsed Helen Junz' critical point about the export of jobs. "We have had technical changes for two centuries – destroying jobs continuously in the process. What people forget is that these changes also raise incomes and increase jobs. Foreign trade destroys particular jobs just as technical change destroys particular jobs. But destroying particular jobs is not the same as eliminating jobs, because in a well-run economy new jobs get created as well."

Responding to Peter Kenen's question about how to get stable exchange rates, Cooper said that he preferred floating until the time had arrived for fixing, rather than opting for a gradual approach. "I think that the Maastricht Treaty in its current design, if taken seriously, ensures a deflationary Europe for the rest of the 1990s. I don't think that is in Europe's interest and I don't think it is in the interest of the rest of the world."

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Closing Address

Wim Kok, Minister of Finance of the Netherlands

Introduction

I am grateful for the opportunity to make some concluding remarks at this conference on the functioning of the international monetary and financial system.

For many people the international monetary system is a rather abstract phenomenon: it is identified largely with the international institutions and their financing mechanisms that were established at Bretton Woods in 1944. It is more, however. It encompasses all players in the monetary and financial playing field of today as well as their interdependence. Therefore, it also needs a spirit of cooperation and it should provide a set of rules: the rules of international coordination; non-discriminatory rules to ensure fair treatment of all participants.

The fitness of the current system should be judged against this background. Has it been able to overcome serious problems in the past and will it be capable of responding adequately to the challenges the world faces today?

The institutions have indeed changed in character and refocused their activities. It should thus not come as a surprise that participants at this conference have not advocated a complete overhaul, though many refreshing comments have been made as to improvements. The Articles of Agreement of the IMF and the World Bank have withstood the passage of time reasonably well. Even as recently as 1991 the European Bank for Reconstruction and Development was modelled on the World Bank, although it has been adapted to the specific circumstances of Central and Eastern Europe. At its imminent fiftieth birthday, the basic architecture of the Bretton Woods sisters still seems to be largely suited for addressing the challenges of today:

- to invest in infrastructure and human resources;
- to restructure the former command economies and integrate them into the world economy;
- to offer opportunities for the developing countries;
- to achieve open trade relationships;
- to stem the deterioration of the environment.

However, the actual performance of the international monetary system so far has been uneven:

1. Some developing countries, especially in Africa, are caught in a trap of severe underdevelopment, insufficiently diversified export opportunities

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and a lack of confidence by investors. In order to restore their structural imbalances they are in need of an adjustment and investment programme, sustained over a long period and accompanied by a sufficient long-term positive flow of concessional resources.

2. Achievements have been made with regard to the financing mechanisms of many developing countries but we still have a long way to go.
3. Concerning the countries in transition the international monetary system itself is still in a process of adaptation.
4. On international monetary coordination among industrial countries the system has encountered severe setbacks in recent years.

Allow me to elaborate these points somewhat.

Developing countries

The mission of the international institutions has changed considerably over the years. More and more, the IMF and the World Bank have focused on developing countries. Regional Development Banks have been founded, joining their forces with the Bretton Woods sisters. All have introduced new elements into their policies, like human resource development, poverty alleviation, sustainable development and good governance. Moreover, new facilities have been established. In trying to provide a more structural solution for the ingrained balance of payments problems of the poorest countries, the IMF has set up a concessional window (ESAF). The general willingness to establish an ESAF successor is a positive signal. The structural shortage of long-term concessional development funds remains a problem, however. The World Bank has started to supply balance of payments loans in order to create a more favourable environment for investment projects. The Brady plan led over the years to a restoration of the external viability of middle-income countries, which were coping with a large debt overhang in the past. Recently, the IMF created the Systemic Transformation Facility to help to face the reform problems of former communist states, thus recognising the special needs of countries that are in the process of overhauling their entire economic system.

Another important initiative is the introduction of the Global Environment Facility in response to growing concern about the global environment. It has now been widely accepted that economic developments cannot be judged properly without taking the environmental context into full consideration. Notwithstanding the legitimacy of our budgetary and economic concerns, there is no excuse for neglecting the well-being of future generations. Therefore, one year after Rio, the Global Environment Facility deserves a higher priority on the international agenda.

There are also other grounds for concern. In many of the poorest developing countries the outcome of continued financial assistance is - to say

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the least - still disappointing. As the Bank for International Settlements illustrated recently, income inequalities between nations are widening instead of narrowing. Moreover, some developing countries remain dependent on financial assistance from the IMF, because they are unable to achieve or maintain macroeconomic stability. Obviously this is due to structural weaknesses, which make them very vulnerable to external shocks.

To what extent could changes in the international monetary and financial system contribute to overcoming these structural weaknesses? The progress of relatively less poor developing countries is mainly the result of internal adjustments. External assistance plays a role in catalysing progress and enabling them to restore the confidence of private capital markets. Although many of these countries remain relatively vulnerable to external shocks, they should be better able to face the increased mobility of international capital through a sufficient build-up of reserves and timely policy adjustments.

Policymakers in the field of development cooperation are looking for ways to increase the leverage of the international monetary and financial system, without damaging the solidity of the monetary system, of course. Proposals such as a large SDR allocation should be judged against this background, an adequate analysis of the long-term global need for reserves and policy proposals to solve imbalances in the distribution of real resources. I am looking forward to the IMF study on this with a great deal of interest.

A global structural adjustment strategy remains necessary. I would like to mention a few elements. Consensus on the characteristics of adjustment policies is growing. This is perhaps the most promising result of recent discussions within international financial institutions. Developing countries with structural weaknesses should reduce their budgetary imbalances and market distortions, and should diversify their export structure, as well as redirect their public spending to productive uses, such as investments in human resources and infrastructure. Of course, as we know from our experience, this is easier said than done. In these cases external assistance can make a difference. Secondly, governments of industrialised countries should remain committed to their efforts to reduce deficits, thus reducing the scarcity of global savings and creating more room for complying with the UN target for Official Development Assistance. Thirdly, we should do everything in our power to open up markets for products from developing countries, allowing them to reap the full benefit from a diversified export strategy and their comparative advantages in labour-intensive products. Even in the poorest countries an increase of export revenues is of even more importance than development aid. I therefore note with satisfaction that in recent years many developing countries have become members of GATT. A rapid conclusion of the present negotiations on the Uruguay Round is crucial for these countries, since trade has proved to be the most suitable instrument to

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outgrow underdevelopment. I hope that the meeting of the European Council can make significant contributions to this end.

Fourthly, solidarity with the poorest countries could be made effective through a continuation and extension of the present policy in the Paris Club. The Trinidad terms as applied at present are indeed a significant step in the right direction.

However, with a view to the gravity of the debt burden of some of the low-income countries as well as some of lower middle-income countries, I hope the Paris Club will be in a position to introduce differential treatment, bringing the degree of concessionality more in line with the debt situation of the country concerned. For example, one could consider a moderate degree of debt reduction for those lower middle-income countries for which the present Houston terms are insufficient. Naturally, determining which countries would qualify for the respective treatments should be done on the basis of objective criteria. Also, as in the past, a precondition for debt reduction should remain the willingness and satisfactory efforts of debtor countries to adjust their economies.

In short: the existing structural imbalances in financial flows should primarily be addressed by a real change in the global economic framework, not by monetary measures alone, which could easily lead to postponing these adjustments.

Eastern Europe and the former Soviet Union

The membership of the countries of Eastern Europe and the former Soviet Union is the latest challenge for the international financial institutions and the international community. To mention only a few of the problems: economic stabilisation, reform and privatisation take on a different meaning in countries which were formerly almost 100% state-controlled. As a first reaction most countries experienced (or are still experiencing) negative growth of considerable magnitude. In most countries the institutional framework needs to be re-established, property rights need to be clarified and sometimes a new currency has to be introduced. The Bretton Woods institutions are confronted with the non-existence of basic statistics; there is a lack of global coordination of programmes, resources and technical assistance; disbursements are slow. On the donor side, the development status of some of those countries still has to be clarified, and there is not always an appropriate burden-sharing among creditor countries.

The adjustment problems of these countries demand what I would call a balanced approach. Strong, but credible efforts are necessary both from the countries themselves and from the international community. All of the transition countries in Central and Eastern Europe and in the former Soviet Union should be treated equally; they deserve equal attention and support.

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I hope that the countries in transition will be successful in transforming their economies. Of course, continued attention from the international community is required in order to limit the adverse effects of the transformation to a minimum.

The extent of the debt problem of Eastern Europe cannot be compared to the debt problem of Latin America in the eighties. Nevertheless, the experience in coping with Latin American debt can teach us lessons on how to assist the countries in Eastern Europe and the former Soviet Union.

The main lesson is the importance for the countries concerned of sticking to sound macroeconomic and structural adjustment programmes. Creating hard budget constraints is the first inevitable step in finding a solution. Furthermore, social safety nets and education and health care systems have to be modified. The political backing for the economic reformers is an absolute prerequisite, which seems to indicate the need for major efforts to muster cross-party support for the main principles of reform and the avoidance of polarisation.

In addition, countries with a large external debt may need exceptional financing by way of debt relief both from the commercial banks and governments necessary to cover the financing needs, in particular during the period of transition. However, the only viable and lasting solution to the problem of foreign reserves shortage of these countries is market access. After the collapse of the communist trade block most of the countries in Eastern Europe and in the former Soviet Union have seen their traditional export markets shrink or even disappear. The EC should set an example in opening markets.

International monetary coordination

Let me finally make a few remarks on international monetary coordination among the industrial countries. It must be said that the quality of coordination of economic and monetary policy has diminished. Financial markets have confronted the world, and Europe in particular, with the consequences of diverging competitive positions and cumulative inflation differentials. Substantial exchange rate adjustments proved necessary in several cases, both within the EMS and in relation to the dollar. This shows once again that closer multilateral surveillance of countries' economic, budgetary and financial performance is called for. The basis for improved coordination among countries should be sound domestic policies: external balance starts at home.

The need for enhanced coordination becomes even clearer when looking at the current economic developments throughout the world. In Europe we will experience no growth in 1993, unemployment is on the rise again from already high levels; while real interest rates continue to be relatively high for

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this phase of the business cycle. Furthermore, as a consequence of growing current account imbalances, conflicts in the field of trade are stirred up. Focusing on bilateral imbalances acts as a political magnet and threatens to start a slide into managed trade.

Fortunately, some positive developments can be reported as well. A successful conclusion of the Uruguay Round might be in sight before the end of this year. Indeed I hope that this time all participants are determined to conclude the negotiations in a cooperative spirit that will let world trade and production prosper. Furthermore, in reaction to the slowdown, the United States, Japan and the European Community have each launched stimulative packages in order to broaden the basis for recovery. This would also be helpful to the world at large. The preparations for the implementation of the EC's Edinburgh initiative are already in full swing. Stimulating economic activity will take place mainly through re-allocating government spending from consumption to investment, most notably in infrastructure. In many countries the automatic stabilisers in the budget are allowed to work. Hopefully, the present combined strategy will show the first results within the near future in order to stop the rise in unemployment and to restore the prospects for sustainable growth.

A stable monetary environment is essential for international trade. An increased role for the international financial institutions is called for. The major industrial countries should be prepared to enable the international institutions to fulfil the tasks allotted to them according to their charters. Too often G-7 initiatives confront the rest of the world with faits accomplis. Since policy measures taken by these major countries have a global impact, the coordination of policy measures and new initiatives should take place through discussions in the appropriate fora like the IMF, the World Bank and the OECD. The fact that G-7 initiatives are to be financed by the international financial institutions also calls for their early involvement.

Conclusion

I will conclude with the main theme of this conference, financial assistance to developing countries. As many of you emphasised, there is a need for adaptations in response to changing circumstances. In some cases financial assistance should be more readily available. This certainly applies to the poorest developing countries. At the same time we should realise that these adaptations will never be a panacea for the problem of underdevelopment. Imbalances in financial flows are often the result of imbalances in the real economy. Without adjustments in the real economy, either within developing countries or in global trade patterns, many developing countries will not be able to restore the balance.

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We very much need international cooperation and coordination. A global economy is emerging fast. Our international institutions must take up the challenge, in the interest of industrialised, transforming and developing countries alike. Our own interests are best served by giving common interests priority. That is a lesson which also applies particularly to international financial institutions in the years ahead.

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Appendix

List of Participants to the Conference on the Functioning of the Monetary System and the Financing of Development, The Hague, 21-22 June 1993

Mr. Ole Moelgaard Andersen	Chief Economic Adviser, Ministry of Foreign Affairs, Denmark
Mr. Dragoslav Avramovic	Director, European Center for Peace and Development, Belgrade
Mr. Gunter D. Baer	Secretary General, Committee of Governors of the Central Banks of the Member States of the EEC, Basle
Mr. Onno de Beaufort Wijnholds	Deputy Director, De Nederlandsche Bank, Amsterdam
Mr. John A. Bispham	Assistant Manager, Monetary and Economic Department, Bank for International Settlements, Basle
Mr. Marc van den Boogaard	Economist, Macroeconomic Aid, World Bank Co-financing and DAC Affairs Section, Ministry of Foreign Affairs, Netherlands
Mr. Marko Bos	Deputy Head, Economic Policy Division, Social and Economic Council, The Hague
Mr. Ariel Buira	Director, Banco de Mexico, Mexico
Mr. Giovanni A. Colombo	Delegate for International Monetary and Financial Affairs, Federal Finance Administration, Switzerland
Mr. Richard N. Cooper	Professor of International Economics, Harvard University, Cambridge Massachussets
Ms. Annette Deckers	Deputy Head, International Monetary Affairs Division, Ministry of Finance, Netherlands
Mr. Robert den Dool	Economist, Policy Planning Section and Advisory Council Secretariat, Ministry of Foreign Affairs, Netherlands

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Mr. Dag Ehrenpreis	Chief Economist, Swedish International Development Authority, Sweden
Mr. Mohamed A. El-Erian	Division Chief, Middle Eastern Department, IMF, Washington
Mr. Marco Ferroni	Chief, Balance of Payments Operations and Debt Conversion, Federal Office of Foreign Economic Affairs, Switzerland
Mr. Ricardo Ffrench-Davis	Principal Advisor on Economic Policy, UN-ECLAC, Santiago de Chile
Mr. Vítor Gaspar	Consultant to the Board, Banco de Portugal, Lisboa
Ms. Stephany Griffith-Jones	Senior Fellow, Institute of Development Studies, Sussex
Ms. Catherine Gwin	Vice President, Overseas Development Council, Washington
Mr. Jan Hamers	Deputy Director, Export Credit Insurance and Investment Guarantees Directorate, Ministry of Finance, Netherlands
Mr. Kai Aaen Hansen	Director, Danmarks Nationalbank, Copenhagen
Mr. Mahbub ul Haq	Special Adviser to the Administrator, UNDP, New York
Mr. Gerald K. Helleiner	Professor of Economics, University of Toronto
Mr. Barry Herman	Senior Economic Affairs Officer, Macroeconomic & Social Policy Analysis Division, United Nations, New York
Mr. Henk Huisman	Economist, International Monetary Affairs Division, Ministry of Finance, Netherlands
Ms. Eva Jespersen	Senior Economist, UNICEF, New York
Mr. Gerben de Jong	Deputy Head, Macroeconomic Aid, World Bank Co-financing and DAC Affairs Section, Ministry of Foreign Affairs, Netherlands
Mr. Gerrit de Jong	Member of Parliament, Netherlands
Ms. Helen Junz	Director, IMF Geneva-office, Geneva

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Mr. Pieter A. Karsdorp	Head, International Economic Analysis and General Policy Affairs, Ministry of Economic Affairs, Netherlands
Mr. Peter B. Kenen	Professor of Economics, Princeton University, New Jersey
Mr. Ad Koekkoek	Senior Economist, Policy Planning Section and Advisory Council Secretariat, Ministry of Foreign Affairs, Netherlands
Mr. Wim Kok	Minister of Finance, Netherlands
Mr. Rudolf W. de Korte	Member of Parliament, former Minister of Economic Affairs, Netherlands
Ms. Sabine van der Laan	Economist, Macroeconomic Aid, World Bank Co-financing and DAC Affairs Section, Ministry of Foreign Affairs, Netherlands
Mr. John Langmore	Member of Parliament, former President of Parliamentarians for Global Action, Australia
Mr. Emile van Lennep	Minister van Staat, former Secretary General of the OECD, The Hague
Mr. Frans van Loon	Director, Emerging Markets Group, ING Bank, Amsterdam
Mr. Arild J. Lund	Head of Economics Department, Bank of Norway, Oslo
Mr. José Luis Malo de Molina	Director General, Banco de España, Madrid
Ms. Ifigenia Martínez	Director, Instituto de Estudios de la Revolución Democrática, Mexico
Ms. Margarida Mateus	Vice Director, Institute for Economic Cooperation, Ministry of Foreign Affairs and Finance, Portugal
Mr. Percy S. Mistry	Chairman, Oxford International Associates, Oxford
Mr. Weert Mostert	Head, Macroeconomic Aid, World Bank Co-financing and DAC Affairs Section, Ministry of Foreign Affairs, Netherlands
Mr. Philippe P. Moutot	Adviser to the Director for Foreign Relations, Banque de France, Paris

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Mr. Richard Portes	Director, Centre for Economic Policy Research, London
Mr. Jan P. Pronk	Minister for Development Cooperation, Netherlands
Mr. Gaston Reinesch	Government Commissioner, Ministry of Finance, Luxembourg
Mr. Jean-Jacques Rey	The Director, Banque National de Belgique, Brussels
Mr. Wolfgang Rieke	Director, Deutsche Bundesbank, Frankfurt
Mr. John Roberts	Head, Aid Economics and Small Enterprise Department, Overseas Development Administration, United Kingdom
Mr. Delphin G. Rwegasira	Director, African Development Bank, Abidjan
Mr. Mario Sarcinelli	Vice-President, European Bank for Reconstruction and Development, London
Mr. Kumiharu Shigehara	Head of Department, Economics Department, OECD, Paris
Mr. Bernard Snoy	Executive Director, The World Bank, Washington
Mr. Esko Sydänmäki	Research Officer, Policy Department, Bank of Finland
Mr. André Szász	Executive Director, De Nederlandsche Bank, Amsterdam
Mr. Jan Joost Teunissen	Director, Forum on Debt and Development, The Hague
Mr. Niels Thygesen	Professor of Economics, University of Copenhagen
Mr. Jan Tinbergen	Professor Emeritus Development Planning Erasmus University Rotterdam, The Hague
Mr. Coen Voormeulen	Deputy Head, International Affairs Department, De Nederlandsche Bank, Amsterdam
Mr. Rob Vos	Senior Lecturer, Institute of Social Studies, The Hague

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Mr. George Waardenburg	Chief Scientist Development Cooperation, Ministry of Foreign Affairs, Netherlands
Mr. Jan Willem van de Wall Bake	Deputy Head, Multilateral Banks Division, Ministry of Finance, Netherlands
Mr. John Williamson	Senior Fellow, Institute for International Economics, Washington
Mr. Ben van der Wolf	Director, UNICEF-Nederland, The Hague

Observer

Carl Gewirtz	Associate Director, International Herald Tribune, Paris

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