John Williamson
Stephany Griffith-Jones
Arjun Sengupta
and others

Fragile Finance

Rethinking the International Monetary System

Edited by
Jan Joost Teunissen

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Fragile Finance: Rethinking the International Monetary System

Proceedings of the Workshop on the Functioning of the International Monetary System, held at the Netherlands Ministry of Foreign Affairs in The Hague on 9-10 June 1992, 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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Contents

Abbreviations

ADR	American Depository Receipts
BIS	Bank for International Settlements
CCFF	Compensatory and Contingency Financing Facility
CD	Certificate of Deposit
CIS	Commonwealth of Independent States
CTC	Chilean Telephone Company
C-20	Committee of Twenty
DFI	Direct Foreign Investment
EC	European Community
ECLAC	Economic Commission for Latin America and the Caribbean
EE	Eastern Europe
EEC	European Economic Community
EMS	European Monetary System
FDI	Foreign Direct Investment
FEER	Fundamental Equilibrium Exchange Rate
FTA	Free Trade Area
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	Generalised System of Preferences
G-7	Group of Seven
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
IMS	International Monetary System
LAC	Latin America and the Caribbean
LDC	Less Developed Country
LIBOR	London Inter-Bank Offer Rate
MITI	Ministry of International Trade and Industry (Japan)
NAFTA	North American Free Trade Agreement
NAIRU	Non-Accelerating Inflation Rate of Unemployment
NIC	Newly Industrialising Country
NTB	Non-Tariff Barrier
OBS	Off Balance Sheet
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PPP	Purchasing Power Parity
SDR	Special Drawing Right
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations Children's Fund
UNU	United Nations University
WIDER	World Institute for Development Economics Research

Preface

The initiative of the Forum on Debt and Development to revive policy debate on the functioning of the world monetary system and the financing of development is most interesting and timely. In the face of dangerous instability of global financial flows it is high time for policymakers to seriously rethink the role they should play in a market-based international monetary and financial system. National as well as international monetary authorities seem to be lagging behind rapid developments in capital markets and to have little control over dramatic swings in these markets. It has become clear that booms and busts in credit expansion and the serious volatility and instability of exchange rates witnessed over the past decades created harmful uncertainty and misleading signals to private investors and policymakers in many parts of the world. Efforts to stimulate discussion about ways to improve world economic stability therefore deserve a warm welcome.

At the end of the Second World War, Europe and the United States of America showed the willingness and ability to cooperate internationally and create an international monetary system which aimed at the material well-being of people all over the world. Nowadays, this international spirit is much less present. National interests and the striving for national sovereignty seem to dominate the minds of policymakers notwithstanding the growing economic and financial integration of the world economy. Of course, Europe is trying to complete its economic and monetary integration, the United States is putting much energy in building a common market in North and South America, and Japan is playing a crucial role in the economic integration of Asia. But the emergence of these regional trade and currency blocs has not contributed to better global decision-making. And the regular meetings of the seven major industrial powers of the world in their G-7 Summits would only partially meet the need for a forum for global macro-economic policy coordination. Unfortunately, the International Monetary Fund so far has not been allowed to effectively function as the 'natural' forum for such coordination. A more representative world economic council working in the context of IMF, World Bank and OECD – but smaller than the present Interim Committee of the IMF – could put the debate on policy coordination in a better and more equitable global context.

The major industrial nations play a key part in the development of the world economy and provide the main markets for developing countries' exports. Therefore adjustment of imbalances in the major economies and a better policy coordination among them seem essential for improving the

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world economic climate.

Economic thinking and policymaking inevitably reflect the vogue of the day. The prominence of monetarism during the 1980s was partly a reaction to unsound Keynesian policies of the preceding period. As a result, fiscal policy was almost abandoned as an instrument and replaced by monetary standards. It is my hope that in the 1990s the fiscal policy instrument will become fashionable again and regain its appropriate stabilising role in national and international economic policymaking. A proper mix of fiscal and monetary policies is now even more needed than before since national sovereignty in monetary matters has become largely illusory as a result of the convertibility of currencies and the free movements of capital.

The new challenges facing the world community, like the support to be given to the transformation of the former communist countries into social market economies, the need for allocating ample financial resources to safeguard the global environment, and the globalisation of financial markets should inspire scholars and officials to engage in creative debate about adequate solutions. The analyses, proposals and discussions presented in this book invite the reader to think about ways in which a more stable and equitable international monetary and financial world could be brought about.

H. Johannes Witteveen
Wassenaar
October 1992

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Introduction

Looking at the history of the international monetary system in the 19th and 20th century, it is not difficult to distinguish the various stages of its development, assess its performance, and explain why subsequent reforms of the system came about. With the benefit of hindsight, it seems logical that the original 'gold standard' (based on the British pound and its convertibility into gold) was replaced by the 'gold exchange standard' (based on the US dollar and its convertibility into gold) after the Second World War, and that this system, in its turn, was abandoned in 1971 when the United States, because of its growing indebtedness to the rest of the world, could no longer guarantee the dollar's value in gold. The more recent history of the world monetary system shows, however, that it is hard to reach consensus on its successes and failures, agree on the reforms required, and, eventually, get sound ideas put into practice.

The past three decades supply testimony to this lack of consensus. Efforts to reform the system, inspired by Robert Triffin's early warnings about the instability of a global monetary system based on the US dollar (or any other national currency) [1] finally failed early 1970s. Instead of putting into practice the reforms agreed in the famous Committee of Twenty report [2], the main policymakers decided to abandon the idea of multilateral control of the system. From that time onwards, the world monetary system rested on two rather fragile pillars: a 'dollar-paper standard', rather than the previous dollar- gold standard, and floating exchange rates, instead of the previous fixed rates.

In the preface to this book, former Managing Director of the IMF, H. Johannes Witteveen, points to some of the weaknesses of the current system: serious volatility of exchange rates, dramatic swings in capital markets,

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1. See Triffin's "Europe and the Money Muddle" (1957) and his classic "Gold and the Dollar Crisis" (1960).

2. The Committee of Twenty (C-20), comprising representatives from the twenty member countries of IMF's Executive Board and chaired by Jeremy Morse, was established in 1972 by the IMF. In 1974, it presented the report "International Monetary Reform", outlining fundamental reforms of the world monetary system. The report was the culmination of more than ten years of discussions and negotiations between experts and officials of the ten major financial powers (G-10), the IMF and, after the establishment of C-20, the developing countries. The recommendations were not implemented; they were officially dismissed at an IMF meeting in Jamaica in 1976.

harmful uncertainty and misleading signals to private investors and policymakers, as well as a lack of global macroeconomic policy coordination.

These weaknesses, which affect the well-being of citizens all over the world, incited the Forum on Debt and Development to attempt a series of activities aimed at reviving policy debate on the functioning of the world monetary system and the financing of development. The first activity considered was a Workshop on the Functioning of the International Monetary System. The task sounded ambitious, but support came soon. Our invitations to experts in monetary, finance and development issues got very positive reactions. Even many of those who were not able to participate expressed great interest in becoming involved in creative discussions about the functioning of the world monetary system.

So, in early June 1992, a group of eminent officials, private bankers, researchers and politicians met in The Hague to discuss three papers prepared by the well-known experts, Stephany Griffith-Jones, Arjun Sengupta and John Williamson. Griffith-Jones investigated the causes of Latin America's renewed access to world capital markets and suggested how policymakers could best address or prevent future problems. Sengupta put forward some challenging ideas about supporting developing countries' efforts to become true partners in a market-driven world economy through new aid and development policies. Williamson reviewed past proposals for reform of the international monetary system and came up with four proposals which, according to him, would be viable today.

The papers stimulated lively and in-depth debate, as the comments and discussions in this book show. While editing the book, I realised, once more, how difficult it is to summarise such comprehensive and profound arguments, since it is almost impossible to fit in every interesting statement and idea that circulated around the table. Some important issues raised by the participants had to be left out.

One of these issues was the whole matter of international commodity prices. Drag Avramovic, in particular, strongly advocated an investigation of what can be done with regard to commodity risk management, running from initial incentives to investment, diversification of markets and products, to stabilisation of prices. "Unless this is done," he argued, "it will be difficult to resolve economic shocks to which in particular the poorer countries are exposed".

Another issue was the long-standing proposal of establishing a world central bank some time in the future. In his paper, John Williamson related that once he was a strong supporter of this idea, but now, in a world of free capital mobility, he no longer regards it as realistic. Other participants, however, felt that precisely because of the reality of capital flowing freely around the world, with not only beneficial, but also disruptive effects on economies, the need for an international institution like a world central bank is even greater.

These two examples illustrate a fundamental problem which academics and policymakers have to address: what order can be brought to trade and finance, both at the national and international level? Or, put in different words: how should the official and private parts of the international monetary system ideally interact? In a world of growing economic interdependence and integration of financial markets, policymakers and private agents are increasingly confronted with the need to strike a proper balance between the market mechanism and official regulation. That basic question was also central in the debates at our Workshop. Some favoured more control by national, as well as international, authorities, others less. There was no consensus.

One of the points, however, on which all participants did agree is that a sensible world monetary system should take into account the interests of all members of the global community. This ideal has inspired experts and laymen from various parts of the world, and is reflected in Witteveen's support for a more stable and equitable international monetary and financial system. The papers, comments and discussions which follow show that such an endeavour is still alive. I hope that these contributions will re-start a debate on these important but somewhat neglected issues.

Acknowledgements

Various people contributed to the organisation of the Workshop and the publication of its proceedings. Without implicating them in any way, I would like to thank in particular Alister McIntyre for his able chairing of the Workshop; Stephany Griffith-Jones, Percy Mistry, and Karel van Kesteren for their many helpful suggestions; Emile van Lennep and H. Johannes Witteveen for their valuable advice; Adriana Bulnes, Philip Hanning, and Niala Maharaj for their skillful assistance to the publishing of the proceedings. The Forum on Debt and Development gratefully acknowledges the support of Minister Jan Pronk's Department of Development Cooperation of the Netherlands Ministry of Foreign Affairs.

Jan Joost Teunissen
Director
November 1992

The Return of Private Capital to Latin America: The Facts, an Analytical Framework and Some Policy Issues

Stephany Griffith-Jones with Ana Marr and Alicia Rodriguez[1]

This paper discusses the massive and rather surprising return of private capital flows to Latin America. This is both a very new and a very old phenomenon. It is very new in that, only three years ago (when the focus was mainly on foreign exchange constraints and the region's debt overhang) such a massive return of private capital into Latin America seemed totally unlikely to most policymakers, market actors and observers. It is a very old phenomenon, however, because private capital has flown in great abundance to the region on many previous occasions since the early 19th century.

We will first analyse the international context of shifting private capital movements in which this phenomenon is taking place. Then we will examine in some detail what and how much is happening to private capital flows to Latin America. As this phenomenon is so recent, it seems essential first to understand, as far as possible, its magnitude and characteristics. This is not an easy task, due to the limitations of existing data and data collection. The next section will attempt to explain recent developments, focussing both on supply and demand factors. We will then try to develop an analytical framework for evaluating the effects of these flows on Latin American countries looking at empirical evidence. The final section presents conclusions, preliminary policy suggestions and some suggestions for further study.

I. THE INTERNATIONAL CONTEXT AND PRIVATE CAPITAL FLOWS TO LATIN AMERICA

International trends

The return of private capital flows to Latin America needs to be understood

1 This paper was prepared for a Workshop organised by the Forum on Debt and Development (FONDAD), held in The Hague on 9-10 June 1992. We thank Nicholas Georgiadis for valuable research assistance and are particularly grateful to Mohamed El-Erian and Ricardo Ffrench-Davis for their valuable comments, as well as to other participants in the FONDAD Workshop for useful suggestions.

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in the context of major changes in capital movements at a global level. During the 1980s, financial markets have been characterised by: 1) their growing integration amongst different countries, market segments, institutions and financial instruments; 2) liberalisation; and 3) the spread of innovative financing instruments and techniques.

These trends are related first to the deregulation of financial services in areas such as prices, interest rates, fees and commissions, a policy trend which began in earnest in the 1980s, and is now almost complete in industrial countries. Furthermore, the restrictions on the range of activities of financial institutions have also continued to erode, both through market practice and through legislative and regulatory action. Indeed, in the three major economies with traditionally segmented systems – Canada, Japan and the United States - there have been moves toward a relaxation of functional barriers. Movement towards geographic integration of financial markets has been particularly marked in recent years within the European Community, especially in the context of the 1992 Single Market programme. Indeed, as the IMF reports,[2] many market participants in Europe (both EC member and non-member countries) view the overall process of European integration as the single most important influence on their activities and strategies for the 1990s. Within the EC, the integration of financial services has been accompanied by discussion of more integrated supervision and regulation, particularly in the field of banking. However, progress in the latter, in certain key sectors such as securities, has been relatively slow, which could perhaps be a cause for concern.

It should be stressed that other factors have also contributed to the globalisation of capital markets. These include important technological advances in telecommunications and computing, which both accelerate and reduce the costs of international operations and the exchange of information. Also, the sharp current account imbalances in major industrial countries during the 1980s led to large flows of funds from surplus to deficit countries, and especially to the USA; this latter trend seems to be diminishing somewhat as Germany's current account surplus disappears and the US current account deficit declines somewhat.

Finally, there are two somewhat related trends, which seem important to highlight in this context. One is the far more rapid growth of securitised forms of lending (such as bonds) than of bank loans (see Table 1). The second is that institutional investors (such as pension funds, insurance and mutual funds), have played an increasingly dominant role in world capital markets.

2 IMF, "International Capital Markets, Developments and Prospects", World Economic and Financial Surveys, Washington, D.C., May 1991.

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Such investors have a greater ability to analyse in depth the changing conditions in different markets than individual investors. This has led many of them to a greater geographical diversification in their investments, with the aim of improving their profits, and diversifying their risks.

TABLE 1 BORROWING ON THE INTERNATIONAL CAPITAL MARKETS

(Amounts in Billions of Dollars)

INSTRUMENTS	1982	1984	1987	1988	1989	1990	1991
Bonds	75.5	111.5	180.8	227.1	255.7	229.9	297.6
Equities	n.a.	0.3	18.2	7.7	8.1	7.3	21.6
Syndicated loans	98.2	57.0	91.7	125.5	121.1	124.5	113.2
Note issuance facilities	5.4	28.8	29.0	14.4	5.5	4.3	1.8
Other back-up facilities			2.2	2.2	2.9	2.7	4.5
Total securities and committed facilities	179.1	197.6	321.9	376.9	393.3	368.7	438.7

Source: OECD Financial Market Trends, February 1992, and previous issues.

Table 1 reflects the evolution of the international capital markets since 1982. A first trend to observe is the very rapid increase in total global borrowing, from \$179 billion in 1982 to \$439 billion in 1991. A particularly large increase (of almost 20%) occurred in 1991, after a contraction in 1990, related to a significant reduction in some of the Japanese bonds. A second trend to observe is the increased importance of bonds in total borrowing. Bonds represented around 42% in 1982, and have increased their share to around 67% in 1991. This increase in the share of bonds in total borrowing has been accompanied by a decline in the share of syndicated loans. This was caused mainly by the attitude of leading international banks against extending new loans other than to prime borrowers. This attitude reflects greater emphasis on containing asset growth within boundaries set by new capital adequacy requirements and on improving the quality of loan portfolios. By contrast, the past and the future situation of the international securities markets is clearly more favourable. Market observers point to the fact that, on a global level, the availability of funds remains ample. According to the

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OECD [3] this positive underlying trend in international securities markets is strengthened by two factors: first, the process of asset diversification may intensify since several "emerging" segments of the euro-bond market have reached the critical size which justifies a heavier weighting in institutional investors' portfolios. Secondly, the maturing of the euro-bond market implies an increase in bond redemptions, which provides investors with an increasingly large source of liquidity that needs to be profitably re-invested.

If euro-commercial paper lending and other non-underwritten facilities are added, total borrowing on international capital markets increased from $392 billion in 1987 to $518 billion in 1991. The share of developing countries in this total borrowing, though still relatively low, increased significantly during the past three years, up from 5.0% of the total in 1988 to 8.1% in 1991. Indeed, the overall recourse to private international markets by developing

TABLE 2 LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL INFLOW AND TRANSFER OF RESOURCES

(Billions of Dollars and Percentages)

	(1) Net capital inflow	(2) Net payment of profits and interest	(3) = (1) – (2) Transfer of resources	(4) Transfer of resources – (%) Exports of goods and services
1975	14.3	5.6	8.7	21.2
1980	32.0	18.9	13.1	12.5
1981	39.8	28.5	11.3	10.0
1982	20.1	38.8	–18.7	–18.2
1983	2.9	34.5	–31.6	–30.9
1984	10.4	37.3	–26.9	–23.7
1985	3.0	35.3	–32.3	–29.7
1986	9.9	32.6	–22.7	–24.0
1987	15.4	31.4	–16.0	–14.8
1988	5.5	34.3	–28.8	–23.4
1989	9.6	37.9	–28.3	–20.8
1990	18.4	34.4	–16.0	–10.6
1991	36.0	29.3	6.7	4.4

Source: UN ECLAC Preliminary Overview of the Economy of Latin America and the Caribbean 1991. December 1991, Santiago, Chile.

3 OECD, "Financial Market Trends", No. 51, February 1992.

countries rose in 1991 by nearly 50% (to $42 billion), the highest level in absolute nominal terms since the early 1980s.[4] Particularly noticeable in this expansion was the very strong growth in borrowing by a number of Latin American countries, which we will discuss next.

Dramatic change of direction and increase of flows

As is well known, in the 1980s, net resource transfers to Latin America and the Caribbean (LAC) were strongly negative (see Table 2). One of the key reasons for this was a sharp fall in private flows to the region, caused mainly by a large decline in private bank lending, that had reached such high levels till 1982. Indeed, according to El- Erian,[5] the total amount of voluntary loan and bond financing flows to Latin American countries during the whole 1983-88 period was considerably smaller than that for 1982 alone.

Starting in 1989, and continuing in 1990 and 1991, there has been a dramatic increase in voluntary new private flows to Latin America and the Caribbean. According to ECLAC, (see again Table 2), net total private flows

TABLE 3 PRIVATE CAPITAL FLOWS TO LATIN AMERICA AND TO SELECTED LATIN AMERICAN COUNTRIES

(Amounts in Billions of Dollars)

	1989	1990	1991
Argentina	1.4	0.5	5.1
Brazil	0.2	0.4	11.6
Chile	1.1	2.0	1.7
Mexico	0.7	8.4	16.1
Venezuela	1.0	1.8	4.8
Regional	0.6	0.2	0.8
Total	5.0	13.4	40.1

Source: Salomon Brothers, op. cit.

4 OECD, op. cit.

5 See M.A. El-Erian "Restoration of Access to Voluntary Capital Market Financing". IMF Staff Papers, Vol 39, No. 1, Washington D.C., March 1992.

TABLE 4 TYPES OF PRIVATE CAPITAL FLOWS TO LATIN AMERICA (1991)

(% of type of flow)

	Total	Argentina	Brazil	Chile	Mexico	Venezuela	Regional
Borrowing							
Bonds, Private Placements & Medium-Term Notes	100.0	13.0	41.2	2.3	54.1	6.9	–17.4
Commercial Paper	100.0				24.1	4.9	71.0
CDs	100.0	27.2	69.1		3.7		
Trade Financing	100.0		65.8		34.2		
Term Bank Lending	100.0	4.2	70.0	13.7	10.6	1.4	
Sub Total	100.0	8.8	42.7	3.3	38.6	4.7	1.9
Portfolio Investment							
Funds	100.0	7.4	16.2	3.4	12.5		60.4
ADRs [1]	100.0	12.9			87.1		–0.0
Sub Total	100.0	11.6	3.7	0.8	69.9		13.9
DFI [2]							
Cash Inflows from Privatisation	100.0	39.1			60.9		
Other DFI	100.0	9.1	12.4	10.5	52.6		15.4
Sub Total	100.0	16.7	9.2	7.9	39.3	15.4	11.5
Other Flows	100.0	15.9	84.1				
Sub Total	100.0	15.9	84.1				
Grand Total	100.0	12.7	29.0	4.2	39.9	7.2	7.0
% of GDP		7.6	2.7	5.8	5.9	10.0	

Note: 1 ADRs = American Depository Receipts
2 DFI= Direct Foreign Investment

Source: Table elaborated by Alicia Rodriguez on the basis of data in Salomon Brothers, 1992 Emerging Markets, op. cit.

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to LACs have increased almost sevenfold since 1988. As a result of this dramatic increase, and, to a lesser extent a decline in net payments of profits and interest, 1991 was the first year since 1981 that the net transfer of financial flows reversed direction and turned positive. Thus, the net outward flow of $16 billion in 1990 was transformed into a new inflow of nearly $7 billion in 1991 (see again Table 2). This represented a turnaround of $23 billion in the net transfer in one year, an amount equivalent to 15% of the region's exports of goods and services.

As can be seen in Table 3, Salomon Brothers [6] even estimates a somewhat more rapid increase than ECLAC, with private capital flows to Latin America calculated to have increased eightfold between 1989 and 1991 and by almost 200% in 1991 alone, reaching over $40 billion.

Country distribution

For 1991, according to Salomon Brothers, there was quite a large concentration of private flows to the two largest countries in the region (Brazil and Mexico), which received almost 70% of inflows (see Table 4). For Mexico (which accounted for 40% of total flows to Latin America in 1991), this represented around 6% of its GDP, while for Brazil it represented 2.7% of its GDP.

In 1991, inflows to Venezuela (at $4.8 billion) are estimated to have reached 10% of the country's GDP, whilst inflows to Argentina reached 7.6% of GDP and to Chile 5.8% of GDP (see again Table 4). The country composition was somewhat different in 1990, when the largest flows went to Mexico and Chile, the two countries which, according to Salomon Brothers, received above 75% of total inflows to Latin America. In 1990, inflows to Chile represented 7.4% of the country's GDP and inflows to Mexico 3.6%.

It is very interesting that, in 1991, not only Chile and Mexico (who had pursued prudent macroeconomic policies and had reduced their debt overhang significantly in the late 1980s) had access to private capital markets, but also countries like Brazil, where important macroeconomic imbalances and a large debt overhang still persisted. However, the terms on which Brazilian borrowers have access to the capital markets are somewhat less attractive. We will return to this issue later on.

Types of flows

It is important to emphasise that the increase in net capital flows to Latin

6 Salomon Brothers, "Private Capital Flows to Latin America: Volume Triples to $40 billion in 1991", February 12, 1992, New York.

TABLE 5 TYPES OF PRIVATE CAPITAL FLOWS TO LATIN AMERICA (1991)

(% of total flows)

	Total	Argentina	Brazil	Chile	Mexico	Venezuela	Regional
Borrowing							
Bonds, Private Placements & Medium-Term Notes	21.2	21.6	30.2	12.0	28.7	20.2	–53.1
Commercial Paper	6.3				3.8	4.3	63.7
CDs	1.6	3.4	3.8		0.1		
Trade Financing	4.2		9.4		3.6		
Term Bank Lending	5.9	1.9	14.1	19.3	1.6	1.2	
Sub Total	39.1	27.0	57.6	31.3	37.8	25.7	10.6
Portfolio Investment							
Funds	3.7	2.2	2.1	3.1	1.2		32.0
ADRs [1]	12.3	12.5			26.8		
Sub Total	16.0	14.6	2.1	3.1	28.0		32.0
DFI [2]							
Cash Inflows from Privatisation	8.8	27.0				74.3	
Other DFI	26.0	18.7	11.1	65.7	34.2		57.4
Sub Total	34.8	45.7	11.1	65.7	34.2	74.3	57.4
Other Flows [3]							
Argentina	1.6	12.6					
Brazil	8.5		29.3				
Sub Total	10.1	12.6	29.3				
Grand Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: 1 ADRs = American Depository Receipts
2 DFI = Direct Foreign Investment
3 Identified by the countries' Central Banks.

Source: Table elaborated by Alicia Rodriguez on the basis of data in Salomon Brothers, 1992 Emerging Markets, op. cit.

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America and the Caribbean has not been due mainly to a return of bank lending, but due to the region's re-entry to capital markets, (especially bonds, private placements and medium-term notes), portfolio investments, and foreign direct investment. In this context, it is noteworthy that the process of the region's market re-entry has been done via a wide range of financing instruments, and involves a wide range of markets, investors and lenders.

Table 5 offers a breakdown of private flows to Latin America in 1991. We can see that 39% of the total flows ($15.7) took the form of borrowing, most of this being in the form of bonds, private placements and medium-term notes. Borrowing was a particularly important source of funds in 1991 for Brazil (see again Table 5). Furthermore, as can be seen in Table 4, in 1991 a very high proportion of short-term flows to Latin America (via for example CDs and trade financing) went to Brazil.

Another important category in 1991 was foreign direct investment, which, at $14 billion, represented almost 35% of total flows into the region. Direct foreign investment is reported to have been a particularly high proportion in Venezuela (where it went mainly for privatisation), Chile (for new investments) and to a lesser extent Argentina (mostly for privatisation, but also in a smaller proportion for new investment (see again Table 5)). Portfolio investment flows represented a smaller share – 16% – of private flows in 1991, with fairly significant proportions in Mexico and in other Latin American countries. In previous years, 1989 and 1990, Mexico and Chile were the Latin American countries that obtained a particularly large share of portfolio investment in Latin America [7]. Indeed, it was a Chilean firm, CTC (Chilean Telephone Company) which was the first Latin American company that sold shares on the New York Stock Exchange since 1963, via American Depository Receipts (ADRs).

Also of interest in this context is the Telmex (Mexican Telephone Company) privatisation, which involved the issuance of some $2.3 billion on several equity markets. This equity offering is reported [8] to be the sixth largest placement of shares in the world (in nominal values).

Length of period and cost

As regards the length of time for which these capital flows are entering, it is encouraging that for some countries, such as Mexico and Chile, and to a

7 P. West "El regreso de los paises latinoamericanos al mercado internacional de capitales privados." Revista de la CEPAL, Santiago de Chile, September 1991.

8 See El-Erian, op. cit.

lesser extent Venezuela, 1991 was characterised by increased levels of longer-term capital flows.

Thus, for Chile, over 65% of the private flows entering in 1991 was via direct investment, all of which was for new investment. For Mexico the figure was almost 35%. Furthermore, Mexico established a new benchmark and reportedly broke a psychological barrier with a ten-year, $150 million Euro-bond issue for NAFINSA (the national development bank). However, on average, Mexican international bond issues have not improved their maturities that much. According to the IMF,[9] for secured issues, average maturities went up only from a 5 year average in 1989 to a 5.5 year average for 1991 (see Table 6); for unsecured issues in the private sector, there has been a more important lengthening of maturities, (from 2 to 4.4 years), but they are still fairly short.

On the other hand, public sector unsecured issues saw their average maturity decline slightly. (Significantly, however, spreads have come down markedly in Mexico, especially for unsecured public issues (see again Table 6)).

TABLE 6 AVERAGE TERMS ON INTERNATIONAL BONDS (MEXICO)

	1989		1990		1991	
	Spread [1]	Maturity (Years)	Spread	Maturity (Years)	Spread	Maturity (Years)
Secured issues	165	5	304	4.4	150	5.5
Unsecured issues						
Public sector	820	5	379	4.9	246	4.2
Private sector	800	2	613	3.6	542	4.4

1 Spread = premium in basic points, defined as the difference between the bond yield at issue and the prevailing yield for industrial country government bonds in the same currency and of comparable maturity.

Source: IMF

9 World Economic and Financial Survey, 1991, op. cit.

From: Fragile Finance: Rethinking the International Monetary System
FONDAD, The Hague, January 1992, www.fondad.org

Aside from direct investment, some bonds and possibly some portfolio investment, the majority of private capital flows to the region has been short-term, especially in short-term money market instruments, where local Latin American interest rates tend to be significantly higher than in the USA. Thus, many American, Latin American and European investors and lenders have been attracted to CDs, Treasury bills, bonds and commercial paper that offer yields at two to four times LIBOR for short-term investments. Table 7 shows estimated benchmark real domestic interest rates and compares them to US$ LIBOR.

TABLE 7 BENCHMARK REAL DOMESTIC INTEREST RATES, 1990-1991

	1990	1991
Argentina (Intercompany lending rate)	47.4%	22.0%
Brazil (Monthly rate - LTN/BBC)	25.4%	32.4%
Chile (90-365 day real annual deposit rate)	9.5%	5.5%
Mexico (28 day CETES rate)	34.7%	15.9%
Venezuela (91 day zero coupon rate)	33.8%	35.5%
US$ LIBOR (6-month average)	8.4%	4.4%

Source: Salomon Brothers, based on national and international sources.

The dramatic drop in short-term US real interest rates during 1991 to a level which (by 1980s standards) was very low, drastically increased the attractiveness of Latin American investment instruments with far higher yields.

It is interesting that US investors, faced with lower interest rates at home, have increased their investments in Latin America by so much, even though

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European interest rates are far higher than US ones. This shows that world financial markets are still not fully integrated.

As Kuczynski[10] correctly suggests, the fact that in 1991 private capital inflows took place even into countries such as Peru which were suffering from significant financial and other problems, suggests that the external forces of funds, driven by sharply lower interest rates in the US markets, were a very powerful explanation of such short-term flows. As we will discuss in more depth in the next section, other factors (including not just high Latin American interest rates but also better economic prospects in the region) have also played a major role.

Sources of funds

It is also encouraging that the investor base of flows going to Latin America has broadened significantly, particularly in 1991, now including money managers, pension funds, mutual funds, insurance companies, finance companies, as well as Latin American investors, the latter either returning capital home or investing in other countries in that region. Furthermore, multinational companies are increasing their direct investments in the region. According to the World Bank, Mexico and Brazil were the top two destinations for investment in developing countries, in the period 1981 to 1991. The prospect of trade integration between Latin American countries, the US and Canada, is further encouraging the formation of strategic alliances between US and Latin American companies.

An interesting issue is whether a large proportion of the capital flowing into Latin America is from Latin American investors repatriating assets previously held abroad. As can be seen in Table 8, estimated repatriation of capital flight in 1990 reached $7 billion (for five major countries in the region). This would represent around 40% of total capital inflows into the whole region during that year (see again Table 2). For 1989, the proportion would be similar. This would seem to give some credibility to the perception of those observers who believe that more than 50% of the capital entering Latin America is from Latin American investors. However, it would seem [11] that a growing proportion of capital flowing into the region originates from sources outside the region, as the potential and profitability of such flows becomes more widely known.

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10 P.P. Kuczynski "International Capital Flows into Latin America: What is the Promise?" World Bank Annual Conference on Development Economics, 1992.

11 Interview material.

From: Fragile Finance: Rethinking the International Monetary System
FONDAD, The Hague, January 1992, www.fondad.org

In any case, the return of capital previously fled is an important and positive trend emerging since 1989. According to Chartered West LB estimates for five major Latin American countries (Mexico, Chile, Venezuela, Brazil and Argentina), there was a total net capital repatriation for 1989-90, of $10.5 billion, which is in sharp contrast with the 1987-88 period, when there was a capital flight of $8.0 billion, implying a turnaround of $18.5 billion in a short period.

As can be seen in Table 8, between the years 1989 and 1990, the situation was quite heterogeneous across these five countries. Mexico, Venezuela and Chile saw important levels of repatriation, while Brazil and Argentina experienced capital flight. Indeed, Brazil – once regarded as an example of a country which avoided capital flight – was consistently losing capital between 1983 and 1990. By contrast, Mexico – a country which traditionally had large capital flight – has had a massive return (estimated at $10 billion) in the 1989-90 period. The Mexican government estimates that a further $5.5 billion returned in 1991. Of the five, the only country that has had a significant net repatriation of capital for the whole 1983-90 period is Chile. This seems to have been due both to so-called economic fundamental factors (strength of macroeconomic policy, good relations with external creditors, private sector orientation, low inflation, positive real interest rates and a welcoming attitude to foreign direct investment) and institutional factors (debt conversion and dollar-swap mechanism). It is noteworthy that the appearance of more

TABLE 8 ESTIMATED CAPITAL FLIGHT (–) REPATRIATION (+), 1983-90

(Amounts in Billions of Dollars)

	Argentina	Brazil	Chile	Mexico	Venezuela	Total
83	–1.7	–4.3	+0.2	–1.8	–4.5	–12.1
84	+0.9	–6.4	+1.2	–3.1	–1.6	– 9.0
85	+0.4	–1.3	+1.0	–4.1	+0.4	– 3.6
86	+1.6	–0.4	+0.6	–2.1	+1.2	+ 1.0
87	–1.8	–1.0	+0.2	–1.6	+0.9	– 3.2
88	+0.8	–1.5	–0.6	–5.3	+1.8	– 4.7
89	–1.3	–1.7	0.0	+5.2	+1.2	+ 3.4
90	+0.3	–1.0	+1.4	+5.5	+0.7	+ 7.0
1983-90	–0.7	–17.6	+4.1	–7.3	+0.2	–21.3

Source: Chatered West LB, op. cit., Developing Country Investment Review, London, March 1991

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FONDAD, The Hague, January 1992, www.fondad.org

sustainable stability given by a successful democratic government (in 1990) led, in that year, to the highest capital repatriation of the period for Chile (see again Table 8). It is important to stress that, at least in the Chilean case, a return to democracy has had a favourable effect on capital repatriation.

II. CAUSES OF LARGE PRIVATE INFLOWS INTO LATIN AMERICA

It is important to understand the causes of large private inflows into Latin America, not only because it is of interest in itself, but also because it would throw light on two relevant policy issues. One is whether the phenomenon is likely to be sustained on such a scale. The other is whether other countries (in the rest of Latin America, in the rest of the developing world and in Eastern Europe) could be equally or at least partly as successful as some Latin American countries in attracting new flows.

One set of factors relates to overall supply conditions. We have already mentioned two key supply factors that have encouraged flows to Latin America; these are the rapid growth and globalisation of world capital markets (especially of bonds and equities) and the dramatic decline in US dollar short-term interest rates. Continued recession or slow growth in the US and Europe further discourage investment there, as do serious debt problems in important sectors like real estate in those countries. The decline in budget deficits in certain countries (e.g. in the UK) in the 1980s also implied smaller demand from traditional alternative investment sources (e.g. gilts) [12]. A reduction in the US budget deficit could have a similar effect.

More generally, it should be stressed that net private capital flows to the Latin American region do not and will not just depend on conditions and policies in those countries, but also on the savings and investment balances in the rest of the world, interest rate differentials, and efficiency and stability in international financial and capital markets.

Before continuing our analysis, it seems worthwhile to stress that it is nonetheless very encouraging that certain LAC countries have regained access to international financial and capital markets at a time (1990/91) when several international factors (declining German current account surpluses, increased demands from EE and CIS, fragility of some international banks) were either problematic and/or highly uncertain.

We will now examine the factors which attracted flows specifically to certain Latin American countries.

Clearly, improved domestic policies and economic prospects in Latin

12 Financial Times Pension Fund Investment, May 7, 1992.

American countries played a key role in attracting new flows to some of the biggest countries in the region, as did other important factors which we discuss below.

Improved domestic policies and prospects

There is consensus that the primary condition for access to foreign flows (as well as encouragement of the return of flight capital by nationals) is the reduction of existing domestic financial imbalances due to improved budgetary performance and prudent monetary policies. Amongst the relevant factors are reinforcement of fiscal revenue effort and positive real interest rates. Secondly, policies that enhance the supply response of the economy are clearly important, including that of production of tradeables. As, for example, the Chilean experience in the 1980s clearly shows, a competitive exchange rate plays a key role in promoting production of tradeables. A third area where domestic policies seem important is improving economic efficiency through structural reforms, such as trade liberalisation, tax reform, rationalisation of legal and other procedures ruling foreign investment, etc.

It should, however, be emphasised that some of these structural reforms, and especially trade liberalisations, have high initial costs, especially if carried out very rapidly and during periods of foreign exchange security, as is well illustrated by the Chilean experience of the 1970s. Latin American countries have also made particularly significant efforts to relax limitations on foreign ownership as a way of attracting foreign direct investment. As N. Lustig [13] emphasises with respect to Mexico, "after 1982 it was no longer possible to wait for foreign investment to follow growth. Foreign investment had to come before growth was in place. It became a needed ingredient for growth...". Therefore major efforts were made to attract it.

Two types of measures that have clearly encouraged foreign capital inflows are: privatisation (and the high rates of return associated with it) and development of the domestic capital markets, especially, but not only, the stock exchanges.

However, there are two areas which, though not so frequently stressed in the academic literature,[14] seem important factors in explaining both foreign

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13 Lustig, N. "Mexico's Integration Strategy with North America" In: C. Bradford (ed.) "Strategic Options for Latin America", OECD Development Centre and IADB, Paris, 1992.

14 Amongst those stressing the direct link between debt reduction and new capital flows, see M. Dooley, "Market valuation of external debt", In: J. Frenkel, M. Dooley and P. Wickan (eds.), "Analytical Issues in Debt", IMF, Washington, D.C., 1990; and S. van Wijnbergen, "Mexico and the Brady Plan", Economic Policy, April, 1991; Sachs, Krugman and others have argued in the similar way.

capital inflows and return of flight capital. One is economic growth or the prospect of increased growth. The former was initially illustrated by the Chilean case and the latter illustrated by the Mexican case, where prospects of growth are not only bolstered by recent figures, but also very crucially by the prospects of the NAFTA with the US and Canada. Furthermore, in 1991, for several Latin American countries, growth prospects both improved and were seen to improve significantly. However, there still remain serious problems, partly inherited from the 1980s, such as relatively low levels of investment and a highly skewed distribution of income. A second additional factor is political stability, preferably in the context of a relatively consensual and democratic political process. The increase in capital inflows into Chile during the first year of democratic government provides evidence for the importance of this factor.

Restructuring of existing debt

Nowadays, there is also agreement in the economic literature that for many countries it is a pre-condition for renewed capital flows that the "old debt overhang" has to be eliminated or significantly reduced. There is now strong evidence (for example from Mexico) that, at least for some countries, there can be a strong complementarity between some debt reduction (as in Mexico via its Brady deal) and increased capital inflows. As had been hoped by the Mexican government, [15] the indirect positive effects of Mexico's Brady deal became more important than the direct effects. The multi-annual Mexican Brady deal, which not only reduced debt service but also shifted amortisations forward for an important number of years, reduced uncertainty and provided confidence. This contributed to indirect benefits (including significantly increased capital flows and return of flight capital), which are estimated – at least in the short-term – to have been more important than the cash-flow effects of the Brady package.[16]

In the case of Venezuela, there is preliminary evidence that its Brady deal has also contributed to increased capital flows. The case of Chile is somewhat different, as its debt overhang was dealt with through pure market-based techniques (mainly via debt-equity swaps) and – in 1990 – a more conventional rescheduling of commercial debt. However, also in this case, the

15 See, P. Aspe, "The Renegotiation of Mexico's External Debt", In: M. Faber and S. Griffith-Jones (eds.), "Approaches to Third World Debt Reduction", IDS Bulletin, Vol 21, No. 2, Sussex, April 1990.

16 For a more detailed discussion, see S. Griffith-Jones, "Is there still a Latin American debt crisis?", Paper prepared for CEPAL, 1991.

reduction of the debt overhang (together with rapidly-growing exports) was an important factor in encouraging new private flows.

However, it should be mentioned here that, rather surprisingly, countries like Brazil and Argentina, which had not reached an agreement with the commercial banks, and (in the case of Brazil) had not yet put "their macroeconomic house in order", have also had access to new capital flows since 1991, though on less attractive financial terms. It is interesting that these new private flows may, in the case of Brazil, contribute to a reduction in the debt overhang, thus reversing the causality observed in other countries. Indeed, the sharp increase in Brazil's foreign exchange reserves in 1991, partly caused by these large inflows, may help the Brazilian government put together a Brady type debt reduction package, since part of these reserves could be used to pay for collateral required by banks for this purpose.

These flows seem to have come in partly [17] on the expectation that Brazil and Argentina will follow the same positive path as Chile, Mexico and Venezuela (a sort of positive regionalisation of expectations). They are also partly linked to the high creditworthiness of companies who are allowed unrestricted access to foreign exchange and have shown a good payment record in the past. However for companies in those countries to borrow significant amounts and at cheaper and longer-terms, it seems an important pre-requisite that the countries' macroeconomic situation improves and that the debt overhang has some kind of definite settlement.

Nevertheless, it is important to stress that the "quality" of the companies attracting the flows (whether public or private, or – as often occurred recently – in the context of privatisation), is a very significant element in attracting new flows. Large well-known creditworthy companies, especially if they are exporters, will find this task much easier. It seems that it is the size and reputation of the companies, rather than particular sectors, which attract foreign flows. Indeed, foreign flows have been attracted by companies in sectors as diverse as oil, paper, tourism, banks, telecommunications and copper mining. Perhaps the major common feature is their ability to generate foreign exchange income via sales.

It is unclear whether small countries in the region (with fewer and less well-known companies in that category) will be able to attract the same scale and type of new private inflows that are now coming into Mexico, Chile, Venezuela, Colombia and possibly Argentina and Brazil. Their task is made even more difficult if they still have an unresolved debt overhang, as several (e.g. Ecuador) do. In this sense, it seems important that: i) they get, where necessary, greater levels of debt reduction than those countries which can

17 Interview material.

already attract new flows; ii) they get strong support from the IFIs in reaching a favourable debt settlement (as commercial banks may be less keen in those cases to do so, and as they may require more debt reduction); iii) they continue to have significant access to official flows; and iv) special efforts are made by IFIs and industrial governments to help those countries to attract private flows.

Reduced transaction costs

Perhaps somewhat less important, but also of significance, is the fact that there has been a reduction in transaction costs for developing countries when entering international capital markets, especially that of the USA. The 1990 approval of "Regulation S" and "Rule 144A" has reduced transaction costs and liquidity problems for LAC countries tapping US markets.[18] Regulation S exempts securities from registration and disclosure requirements (with costs for first time LDC issues estimated formerly in the order of $500.000 to $700.000). Simultaneously, the adoption of rule 144A reduced the loss of liquidity associated with "private placements" (in the past buyers of securities through private placements had to hold them for at least two years after the initial offering). Since 1990, "qualified institutional buyers" (e.g. entities managing and owning at least $100 million in securities) have had the two-year holding requirement relaxed.

According to reports, these changes have also reinforced the possibilities offered by the American Depository Receipts (ADR) programme without meeting the full costs of offerings/listings. This has helped LAC countries (e.g. Chile, Mexico, as described above) to place shares on the US market.

Also, access to bond markets for LAC countries has been facilitated by market-credible credit ratings, thus reducing investors' costs, and allowing access to new segments of the international capital markets, with Mexico receiving its first credit rating by Moody's in December 1990. The ceiling rating for Mexican debt was set at Ba2, just below investment grade, but there seem to be good possibilities for an upgrading. Indeed, it could be argued that the market is already giving investment grade to Mexico and the credit ratings are lagging behind.

These improvements in access to US capital markets should also be accompanied by similar (or equivalent) changes, if necessary, in European and/or Japanese markets. Some steps have already been taken. For example, in June 1991, the Japanese authorities lowered the minimum credit rating

18 G. Pfefferman and A. Madarassy "Trends in Private Investment in Developing Countries", Discussion Paper, IFC Washington, D.C., 1992.

standards for public bond issues on the Samurai market (from single A to triple B). In Switzerland, steps are being taken to abolish minimum credit requirements.

Possibility of customising financial instruments

One option for improving access to capital markets, especially by countries at a stage when they are fully re-establishing (or establishing) their reputation in those markets, is to provide explicit credit enhancements via collateralisation. This can be done, for example, on the basis of existing assets, such as deposits abroad, or expected streams of receivables – such as Telmex's attracting investors by providing them a claim on payments due to it by the US company AT & T on account of international communications. Another technique recently used by LAC borrowers has been enhancement by early redemption options, and particularly by a "put option" which provides the holder the discretion to resell (put) the bond to the borrower at a predetermined price.

Such mechanisms have been used innovatively in recent years by Mexican, Venezuelan and other LAC companies. Their use could be broadened, if necessary, to companies and countries that need to offer this type of "comfort", and to investors who still are somewhat worried about credit and transfer risk. However, possible costs of extensive use of this mechanism need to be carefully evaluated, and should be a cause of some concern. These costs include, in particular, the reduction of flexibility for the country and the company of use of future income, as well as costs associated with legal and technical arrangements. These should be compared with the advantage of initially helping restore market access and of possibly obtaining funds cheaper than would have been otherwise possible. More broadly, the proliferation of explicit or implicit government guarantees should be avoided, unless they are essential.

Other structural elements

As regards foreign direct investment there seem to be additional, more structural elements, which influence its level apart from the factors outlined above. A 1992 IFC study [19] concludes rather categorically that recent research suggests that the traditional determinants of FDI levels, such as labour costs and country risk have become far less important than in the past. On the contrary, structural factors – such as the availability of an educated

19 G. Pfefferman and A. Madarassy "Trends in Private Investment in Developing Countries", Discussion Paper, IFC, Washington, D.C., 1992.

and highly skilled work-force, market size, quality of infrastructure, level of industrialisation and the size of the existing stock of FDI, as an indicator of the quality of the business climate in the country – play an increasingly important role.

III. SUGGESTIONS FOR AN ANALYTICAL FRAMEWORK FOR EVALUATING THE EFFECTS OF THE RETURN OF PRIVATE CAPITAL FLOWS TO LATIN AMERICA

Undoubtedly, the fact that private capital is flowing back to certain major countries in Latin America is a very positive trend, reflecting international recognition of those countries' improved growth performance, international competitiveness and declining inflation. Both policymakers and major social actors in those countries clearly deserve praise for having achieved the important turnarounds in their economies that have encouraged renewed access to private capital markets so soon after the major debt crises of the 1980s.

While welcoming these trends, however, certain policy questions need to be asked. Are the current high levels of net private flows to those countries likely to be sustainable for a long period? Are the terms, in relation to maturities, costs and guarantees (particularly of borrowing) not too onerous for the recipient economies? Are the risks taken by lenders/investors eventually not going to become too high? Are the external resources being productively invested in the country? Is a sufficiently high proportion of this investment in foreign-exchange-generating economic activity that will help service the debt or generate other flows from abroad? Are these large flows not having undesirable (besides clearly desirable) macroeconomic effects on recipient economies? What measures are being taken by governments of recipient economies to counteract such problematic effects, and how effective are they? It seems rather urgent to conduct fairly detailed empirical research which will provide a more solid basis for answering such questions.

On a more positive note, questions need to be asked by other developing countries as well as East European countries and CIS Republics about the lessons that can be learnt from Chile, Mexico and others on how they can regain or gain access to international private capital markets? Is it likely that other countries (in Latin America, but also in poorer parts of the world, like in Africa) can gain/regain access to new private flows? Or are there structural reasons which make it more difficult? If so, what can be done, within and outside those countries, to help them gain access to private capital markets?

What role should be played by guarantee mechanisms, for example via the World Bank and/or regional banks to encourage new private flows to the poorer, less creditworthy countries?

Returning to the Latin American countries that have regained market access, policy questions need to be asked both in the countries from which the flows originate and those in which they are received. At one level: what can be done to improve and make sustainable access to developed countries' flows by such countries? What can be done especially in improving access to flows that are more long-term and have lower, as well as less-variable, costs? At another level: should regulators and supervisors in developed and developing countries increase their monitoring, supervision and regulation, especially with regard to the new categories of flows that are coming in, such as, for example, portfolio investment? How best can a balance be achieved which satisfies the needs of prudence without unduly constraining access to LDCs?

The need to ask this type of question arises both out of economic history and out of economic analysis. Writers such as Bagehot, [20] as far back as 1873, and, more recently, Kindleberger, [21] have pointed out that private capital markets tend to be characterised by successive periods of over-lending and under-lending, often resulting in costly financial crises. Kindleberger, op. cit., analyses the pattern of boom (usually in times of upward movement in the business cycle) and over-contraction of lending, usually in times of slow-down of economic activity, and has illustrated this pattern with historical examples, going as far back as the South-Sea Bubble. Marichal and others [22] have depicted the five great debt crises as resulting from the earlier lending booms which occurred in Latin America since Independence: in the mid-1820s, the mid-1870s, the early 1890s, in the 1930s and in the 1980s.

A particularly useful framework of analysis for current new flows is suggested by a recent paper of Corden, and by John Williamson's comments on it, [23] which focusses on the lessons offered by the lending booms in the 1970s and the debt crises of the 1980s. Using empirical analysis, Corden examines the phenomena of increased spending in developing countries

20 Bagehot, W. (1873), "Lombard Street: A Description of the Money Market", J. Murray, London, 1917 (reprinted edition).

21 Kindleberger, C., "Manias, Panics and Crashes: A History of Financial Crises", Macmillan, Basingstoke and New York, 1978.

22 Marichal, C., "Historia de la deuda externa de America Latina", Alianza Editorial, Madrid, 1988.

23 M. Corden, "Macro-economic Policy and Growth: Some Lessons of Experience", J. Williamson "Comment on Corden's paper", both In: World Bank, Proceedings of the World Bank Annual Conference on Development Economics 1990, Washington, D.C., 1990.

whether for consumption or investment, caused mainly by ready availability of funds from world capital markets. He stresses public spending booms, but recognises that private sector booms have similar effects in practice (as illustrated by the Chilean experience in the 1970s and early 1980s).

Two effects of the booms need to be carefully distinguished. The first is the Keynesian effect, which is reflected in higher demand for locally-produced goods and a reduction of the foreign exchange constraint, in a short-term rise in the growth rate. To the extent that the increase in demand (and the inflows of capital) is temporary, this Keynesian boom is temporary. Not only the rate of growth of output initially rises, but to the extent that the boom was financed by foreign flows, spending can grow even faster. Once – and if – a debt crisis starts, investment and growth of output fall (often drastically), debt service payments rise very fast, and the rate of growth – or the level of national income – falls even more. Usually in the first phase, there is an appreciation of the exchange rate, as the capital inflows create a "Dutch disease" type of pressure, often welcomed by governments, understandably anxious to lower inflation or avoid its increase.

The second type of effect of lending booms, which must be carefully distinguished from the former, is on growth of capacity (on the supply side). It is crucial here what proportion of external flows goes to investment in the country, how productive it is, and what proportion of it is – directly and/or indirectly – converted into tradeables. If enough efficient investment takes place and output rises sufficiently (and is converted into tradeables in a large enough proportion), it is more likely that future debt service or other flows generated by the original inflows can be financed without problems.[24] The rise in debt or foreign investment will not have been a problem; indeed, it will have temporarily increased the rate of growth and made the country permanently better off. Surprisingly, what Corden does not mention, is that, if other positive effects are unchained (such as increased productivity of investment and/or increase in domestic saving and investment), the long-term effects on growth can be even bigger and more sustainable.

However, there is also a less rosy scenario. If increased investment proves insufficient and/or inefficient (the latter, either because it was ex-ante inefficient or because unexpected adverse movements of international interest rates, terms of trade or other changes occur) and if not enough production of tradeables is generated, then the initial output growth is followed by a debt problem, leading possibly to reductions in total absorption, below levels that

24 For a more detailed discussion, see S. Griffith-Jones, "International Financial Markets; A Case of Market Failure", In: C. Colclough and J. Manor (eds.) "States or Markets? Neo-liberalism and the Development Policy", Clarendon Press, Oxford, 1991.

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can be sustained in the absence of the earlier boom. Thus, the total effect (through time) of such flows on the country's retained income can be negative, even if the effect on output may have been positive initially.

The rosy scenario is more likely to materialise if the modality of flows is better suited for long-term growth. This implies preferably long-term, low cost modalities, or even better mechanisms where outflows are linked to results.

In this context, it is important that LDC borrowers make use of the instruments available on the market which reduce vulnerability to variables such as commodity prices and international interest rates, and that they contribute to the further development of such instruments. Short-term lending at variable interest rates is, on the other hand, particularly undesirable, as the experience of the 1980s so dramatically shows.

Because of the risk of the less rosy scenario occurring, precautions would seem essential – to minimise such risks and to maximise the likelihood that both lenders and borrowers obtain not just short-term but also sustainable benefits from such flows. A strengthening of international public compensatory mechanisms (e.g. via enlargement of the IMF facility for this purpose) could give an additional layer of protection against instability in international variables such as commodity prices and interest rates.

However, it should be stressed that the renewal of private flows to Latin America in the early 1990s has played a key role in helping kick-start economic recovery, in reviving domestic private sector confidence and in increasing government revenues, thus making the funding of urgently-needed social spending possible. The value of this initial, positive Keynesian effect of foreign flows should therefore not be under-estimated, especially in a region emerging from a "lost decade" in terms of growth and development.

IV. CONCLUSIONS AND POLICY SUGGESTIONS

Drawing on this framework, it seems important to stress the following:

1. Regarding the scale of private flows, and especially debt-creating ones, it seems desirable that all involved err on the side of prudence. It is when international private flows represent a very large proportion of developing countries' GDP or (in particular) exports, that their impact on borrowers and lenders are more likely to become problematic.

2. Some type of flows seem more desirable than others, and, where possible, recipient and originating countries' governments should encourage a desirable mix. Foreign direct investment, on the whole, seems more desirable than

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lending: it tends to imply more careful cost-benefit calculation by investors, is more likely to bring additional efficiency gains, and profit-remittances tend to be more closely linked to the success of the project than debt servicing. (However, in some cases the rates of profit remittances may surpass debt servicing. This is a subject where more recent analysis of empirical trends may be required.) Within borrowing, longer maturities are obviously preferable to short-term ones; fixed interest instruments are preferable to variable interest ones, unless expectations of declining interest rates are strong, and – obviously, but often forgotten – borrowing at very high cost may (unless the country has no other option) be less desirable than not borrowing at all.

Most of the private flows of the early 1990s seem to have a better profile than those of the 1970s, in that a higher proportion (e.g. Chile and Mexico) comes as foreign direct investment, and a higher proportion of lending to some countries (e.g. Mexico) comes via fixed interest bonds. Furthermore, as discussed above, the conditions on bonds (particularly for Mexico) have improved rather significantly, especially in terms of the large reduction in risk premiums. In the case of Brazil and Peru, a large proportion of flows seems to come in via rather short-term and high cost lending, which is far more problematic.

This leads to two preliminary conclusions. One is the need for the recipient countries and international institutions such as the IMF and the BIS, to monitor carefully and precisely all capital inflows into different Latin American countries, as well as their conditions. This is no easy task, as some of the flows may not be currently registered, and as there are methodological problems (such as, for example, calculating effective yields on bonds rather than initial yields, which are normally recorded). Efforts need to be made in this direction, to avoid the problems of the 1970s, when information on private flows was so insufficient that it contributed to incorrect decision-making. A second conclusion is that it may be necessary for recipient countries in particular to discourage excessive inflows, particularly of certain types. In this sense, recent measures by the Chilean, Mexican and Brazilian Governments (through different mechanisms) either to discourage all flows or more short-term ones, were clearly well taken. Further measures may be required in those or other countries if capital continues to flow at excessive levels.

As regards type of flows, it has been argued that there is a smaller risk of negative effects if the flows originate from and go to the private sector. In relation to bonds, Tables 9 and 10 clearly indicate that for Mexico (in 1991) and Brazil (1991) most of the bond finance went to the private sector, though in the case of Mexico, the situation was different in 1989 and 1990 (see again Table 9). Though this should provide some comfort, as the private sector is

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likely to be more efficient than state enterprises, it should be remembered that some of the previous boom-bust lending cycles also involved private actors as both lenders and borrowers.

TABLE 9 MEXICO: ISSUE OF BONDS, BY TYPE OF BORROWERS

	Number of Issues			Amount in %		
	1989	**1990**	**1991 ***	**1989**	**1990**	**1991***
Public						
Sovereign			2			
Banks		4	1	29.9	21.9	5.1
Development banks		2	1		4.4	6.4
Eximbank	1	1	2		6.6	8.9
PEMEX		4	3		11.0	14.0
TELMEX	1	2		47.8	22.6	
CFE		1			10.3	
Sub total	2	14	9	77.6	76.7	34.4
Private						
Banks		1	2		2.2	4.8
Cement	1	1	2	22.4	4.4	29.3
Mining		2			6.6	
Telmex			1		0.0	29.0
Tobacco		1			2.9	
Oil		1	1		1.4	2.5
Steel		1			2.2	
Others		2			3.6	
Sub total	1	9	6	22.4	23.3	65.6
Total	3	23	15	100.0	100.0	100.0

* Till September 1991

Source: Data based on Banco de Mexico information.

TABLE 10 – 1991 BRAZIL –

	Issues	Amount ($ Million)	Percentage
Public			
Sovereign			
Banks			
Development bank	1	55	1.61
Eximbank			
PETROBRAS	5	842	24.72
TELEBRAS [1]	2	225	6.61
Sub total		1122	32.94
Private			
Steel	1	200	5.87
Bank	2	130	3.82
Celulose	1	40	1.17
Computers	1	100	2.94
Deriv. Oil	1	50	1.47
Chemical	3	120	3.52
Others	4	186	5.46
Others <$20 m		1458	42.81
Sub total		2284	67.06
Grand total		3406	100.00

1 It is expected that Telebras will start being privatised in 1993.

Source: Data based on Salomon Brothers, 1992, op. cit.

While private actors may be more efficient at taking decisions and managing enterprises at a microeconomic level, governments and public international organisations do have an advantage in analysing trends at a macroeconomic level, and evaluating whether the sum of microeconomic decisions taken by private actors is efficient and sustainable in the present and

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future. Hence, there is a need for government monitoring, supervision and regulation of private flows.

Furthermore, as regards private investors (especially in bonds) it is interesting that the risk is not wholly taken by them, as most bond issues (particularly to private sector borrowers) are either collateralised by receivables and letters of credit, or have put options; this puts part of the risk on the borrower. Though attractive and ingenious as a mechanism for helping re-entry to capital markets, it implies that investors may not evaluate the risk as fully as they would in other circumstances, and as a result, the supply of finance does not reflect pure market considerations.

More broadly, private lenders and borrowers (and especially large ones) may assume, based on past experience, that there are implicit government guarantees on their flows, further increasing supply beyond 'pure' market levels. This provides a particularly strong theoretical and practical reason for government supervision and regulation at the stage when new flows are expanding, as governments may be dragged in at a later stage anyway to bail out the private sector at taxpayers' expense if things go wrong. Even more generally, it can be argued that because financial markets are prone to over-react in both directions, and this may have severe costs for society as a whole, the need to avoid such market failure justifies the need for regulation and supervision.

3. It is necessary that the projects financed with new flows should be carefully evaluated using cost-benefit techniques, which compare the present value of estimated total costs with revenues, and examine, in particular, the estimated foreign exchange cost-benefit balance of individual projects, as well as the overall sum of costs and benefits for all inflows. As Corden and Williamson, op. cit., correctly point out, due account needs to be taken in such evaluations of the likelihood of future devaluations, if and when the lending boom diminishes.

As risks tend to be distributed in an unclear fashion among private lenders/investors and borrowers, and among private and public institutions (both in originating and recipient countries), it seems important that at least one actor carries out rigorous and careful cost-benefit analysis. In this sense, it would seem desirable that governments in recipient countries either carry out such analysis themselves or verify strictly that the private sector is doing so, and provide the necessary technical assistance if required. It is naturally essential that such evaluations, and other necessary supervisory or regulatory measures (e.g. of local stock exchanges) are not done in a way that would stifle such flows with unnecessary red tape. The need for agility should, however, be combined with a minimum of prudence. Such a balance is not easy, given the speed with which booms of lending/investment originate and develop, as well as the large scale on which they often take place. Relevant timely and independent technical assistance (from IFIs, developed country regulators, from other LDC regulators) may be very valuable; rapid exchange of information among regulators of different sectors (banking, securities, others) and different countries may need to be organised on a systematic basis. Regulatory and information gaps need to be filled quickly if the creation of new markets has not yet been accompanied by appropriate supervisory and regulatory institutions.

In the case of developed countries, the need for more appropriate regulation and supervision of flows to developing countries in certain sectors (e.g. insurance companies, pension funds) needs to be put in a broader context of appropriate regulation of all these institutions' investments.

4. Difficult issues of macroeconomic management are raised for recipient countries, especially as regards their level of spending, control of the money supply and level of the exchange rate.

As Williamson and Corden, op. cit., clearly conclude, countries should try to restrict their spending to the level of their permanent income. Equally, they need an exchange rate that is consistent with long-term equilibrium in the balance of payments. However, in practice, these are complex matters, as for example the level of permanent income or of an "equilibrium exchange rate" crucially depends (amongst other factors) on how large and how permanent private capital flows will be, on future evaluation of terms of trade, international interest rates, etc. Again, erring on the side of prudence may be advisable, as regards some counter-cyclical policy and the avoidance of excessive over-valuation.

Further policy-relevant research is required, which analyses the policy dilemmas in the new circumstances (both internationally and nationally), taking into account the far more deregulated international environment and the greater openness and reliance on market forces of recipient economies. Interchange of policy experiences amongst countries, and an analysis of their effectiveness, will be valuable; European experiences, for example in the case of Spain in the late 1980s, may provide interesting lessons for LAC countries receiving massive inflows of capital.

5. Finally, it should be emphasised that creditors and investors do have very good long-term reasons for channelling funds into certain Latin American countries. These have made major and costly efforts at very successfully restoring macroeconomic equilibrium, under very difficult circumstances; they have also introduced a number of structural reforms, which have dramatically increased those countries' ability to augment exports. Partly, as a result of such efforts, growth has increased in some countries (though

investment levels are still relatively low) and inflation has come down. More importantly perhaps, there is strong consensus within these countries for continuation of such policies.

There is, however, perhaps need for a final word of warning. This is for both lenders/investors to beware of euphoria; also, successful governments in Latin American countries would probably do well to remember Williamson's, op. cit., wise, though apparently conservative suggestion, that all positive shocks should be treated as though they were transitory and all negative shocks as though they were permanent. The most hopeful element about the new situation is perhaps precisely that in many aspects most Latin American governments (though clearly not all) seem to be taking such advice seriously. If this continues, perhaps the new private capital inflows to them may be sustainable in the medium-term, and the "rosy scenario" may materialise, as it has in some selected developing countries, such as South Korea.

Besides prudence in financial and macroeconomic matters, as well as the other elements discussed above, a pre-condition for the "rosy scenario" may be sustained efforts, e.g. by increases in government social spending, in education and health to improve the welfare of the poorest groups in Latin American countries. Besides it being equitable, such measures would both improve political stability and sustainability and contribute to human capital development, essential both for growth and for attracting long-term capital flows. Furthermore, given the current macroeconomic situation, such increases in social spending could be more easily funded in a non-inflationary manner. Indeed, for example, the very fact that international and domestic interest rates are declining for many Latin American governments, as well as the revaluation of their currencies, eases the domestic currency cost for those governments to service their debt, both domestic and foreign. This allows them some room for increasing social spending in a non-inflationary way.

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Comment on "The Return of Private Capital to Latin America," by Griffith-Jones

Mohamed El-Erian [1]

Griffith-Jones' paper discusses Latin America's restoration of access to private capital flows – a process characterised as "massive and rather surprising" and which raises public policy issues of both country-specific and systemic nature. In line with the paper's coverage, my comments are organised along three related topics: (i) the facts; (ii) the causes; and (iii) the policy implications. An underlying theme throughout the comments is the sustainability of the market re-entry process – an important issue in the context of this workshop's broader deliberations on the functioning of the international monetary system.

The facts

The paper admirably documents the large magnitude of private capital flows to Latin America, and the dramatic speed of the turnaround from the credit-rationing regime. The process – which is best viewed within the overall evolution of the "international debt strategy" – may be considered to have started in earnest just three years ago with the Mexican Bancomext bond issue. Since then it has expanded in several ways, including to encompass: (i) a broader range of countries; (ii) a growing investor base; (iii) greater private sector participation on the recipient end; and (iv) a multitude of financing instruments such as external bond and equity placements, foreign direct investment inflows, flows to domestic equity markets, and capital repatriation. International bank lending, the "locomotive" in the pre-1982 episode of large-scale voluntary flows to Latin America, is the notable exception. The large inflows have been accompanied by an improvement in terms, as illustrated in the lengthening of maturities and reduction in interest rate spreads for bond placements by Latin American countries with recent debt servicing problems.

Overall, therefore, there is support for Griffith-Jones' view that the process has become more extensive in nature. Nevertheless, it is still limited and

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1 These comments represent the views of the author and do not necessarily represent those of the International Monetary Fund.

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touches directly only a portion of developing countries with recent debt servicing problems. Indeed, many developing countries outside Latin America continue to have limited access to international capital market funding. Moreover, and this is also a matter of concern for industrial countries, the linkages across investors and across financial instruments warrant consideration of possible systemic risks in this phase of the international debt strategy. In this context, the paper correctly points to the importance of compiling comprehensive data – the foundation to analytical work and adequate policy response.

The causes

Two related groups may be identified in an analysis of factors behind the restoration of access to private capital flows. The first pertains to the efforts of the re-entrant countries themselves; the second concerns the international environment. Discussion of these factors also sheds light on the sustainability issue.

In discussing the efforts of the re-entrant developing countries, one cannot over-emphasise the importance of sustained economic adjustment and reform policies. Such policies allow for a reduction in country transfer risk which, in turn, provides for a consolidation of access to debt flows and foreign direct and portfolio investments. Accordingly, Griffith-Jones' emphasis on supply enhancement measures is well placed. To result in higher investment and sustained economic growth – the critical determinants of medium-term creditworthiness – these measures must be consistent with internal and external financial stability (i.e., a viable balance of payments position and low and stable domestic inflation).

The process of market re-entry must also be supported by appropriate debt management policies covering both the "old stock" and the "new flows". Here, Griffith-Jones's focus is on appropriate utilisation of existing debt management options including collateralised debt and debt service reduction exchanges for old debt (so-called "Brady-bonds") and credit enhancements for new debt. This focus may be contrasted to the approach taken in Williamson's paper, where the emphasis is on the need for institutional change in the form of an "International Debt Restructuring Agency" [2]. This agency would be charged with revising the terms of contracts, triggered by pre-specific events.

As noted by Griffith-Jones, officially supported debt and debt service reduction instruments provide for a flexible approach to restructuring of

2 See Williamson's paper "International Monetary Reform and the Prospects for Economic Development" in this book.

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existing indebtedness consistent with debtors' longer-term debt servicing capacity, while safeguarding access to new flows. It is not clear whether a new agency would add much to the existing restructuring options. Indeed, an "institutionalisation" of the process through the creation of what is effectively an international bankruptcy mechanism may, at this stage of the debt strategy, have direct costs in terms of discouraging new flows. Alternatively, the agency's effectiveness may be undermined as creditors react by seeking seniority status relative to its procedures through the inclusion in loan contracts of specific waiver clauses.

Institutional strengthening may be of greater relevance in the case of foreign direct investment. This source of inflow has tended to attract relatively little – albeit increasing – attention in the literature, including in Griffith-Jones' paper. Yet, it is a source of external savings that offers the prospects for "servicing" requirements that are most closely linked to the performance of the underlying investment – a phenomenon that enhances developing countries' growth prospects and places a larger direct responsibility on adequate investment feasibility and appraisal work by foreign investors. Recent international initiatives include the establishment of the Multilateral Investment Guarantee Agency. As in other areas, a delicate balance has to be struck between providing adequate institutional support and limiting moral hazard risks associated with implicit or explicit official insurance schemes.

Turning to country-specific measures, there is a growing consensus on the limited effectiveness of ad hoc incentive schemes in promoting long-term productive foreign direct investment. Experience shows that ad hoc provision of generous investment incentives (such as tax holidays, duty rebates, etc.) generally constitutes a poor cost-effective approach for promoting such investments. Rather, the emphasis must be on ensuring the consistency and sustainability of the enabling environment through appropriate economic and financial policies.

Griffith-Jones' paper makes an important distinction between endogenous, country-specific factors which explain the re-entry to capital markets, and factors that may be deemed essentially exogenous from the viewpoint of developing countries. While these factors have contributed to higher inflows, they have added volatility to the process of restoration of access to private capital. The reduction in short-term nominal yields on U.S. dollar denominated short-term financial instruments is viewed as contributing to investors' search for higher returns in Latin American countries. This has been accentuated by the on-going process of integration and internationalisation of national financial markets.

In addition to shedding light on the magnitude of flows, the structural changes in financial markets also hold the key to explaining the rapidity of the turnaround. The integration of market segments within and among industrial countries (and a few developing countries) has dramatically increased the mobility of financial flows and shortened the response time for these flows. This also provides the potential for an equally rapid U-turn, particularly in the context of an increase in nominal short-term yields in industrial countries. Accordingly, an important issue for an appropriate functioning of the international monetary system is the extent to which the large flows to Latin America reflect adequate investor evaluation of improvements in country fundamentals – an issue that, as noted below, is influenced by perception of implicit or explicit safety net mechanisms extended by the official sector. The weaker the linkage to recipient country fundamentals, the larger the scope for disruptive outflows, with potential negative contagion effects on other areas of the economy.

The policy implications

Having reviewed briefly the factors behind the restoration of access to private capital flows, let me now turn in earnest to the third topic – the related policy issues. Analysis of these matters need to extend beyond the coverage of the paper. This is best illustrated by organising the comments into three groups covering: (i) re-entrant developing countries; (ii) other developing countries, particularly those with recent debt servicing problems; and (iii) industrial countries. Together, they shed light on the sustainability of the re-entry process and its implications for the functioning of the international monetary system.

As noted by Griffith-Jones, the return of voluntary capital flows raises several policy issues for re-entrant countries. These include: how to manage the process in order to minimise the risk of a "re-exit"; how to contain the potential adverse impact on domestic financial balances; and how to maximise the positive externalities, particularly for domestic financial markets. These issues are of special importance to Latin American re-entrants for which markets have already discounted future policy adjustments and commercial bank debt reduction packages.

Analysis of the experience of relatively well-established re-entrants (e.g., Mexico) [3] clearly points to the need for a judicious policy mix that builds upon the factors that contributed to the re-entry – viz., (i) prudent macroeconomic policies that alleviate short-term financial pressures; and (ii) restrained borrowing, combined with well-timed placements of benchmark issues in various capital market segments and avoiding implicit or explicit government debt guarantees of private sector borrowing. Griffith-Jones'

3 See, for example, El-Erian, "Mexico's External Debt and the Return to Voluntary Capital Market Financing", IMF Working Paper, WP/91/83, Washington D.C., August 1991.

analysis goes beyond these factors to advocate direct intervention to reduce the share of volatile flows. While some of the proposed measures appropriately strengthen the prudential regulatory and supervisory regime in developing countries, their overall impact would be limited in the absence of a change in the parameters that induce the flows in the first place. Moreover, fine-tuning of policies to differentiate the treatment of different types of capital flows is inherently difficult. Accordingly, the policy emphasis must remain on securing the economic and financial fundamentals that provide for greater efficiency in the use of the capital inflows and reduce exposure to sudden reversals in flows. In addition – and this is an issue that deserves attention in discussions of consolidating the restoration of access to private flows – there is a case for increased use of available risk management instruments to reduce vulnerability to external shocks. Thus, countries' improved creditworthiness also provides access to cost-effective market-based hedging tools that limit the impact of unanticipated adverse developments in commodity prices and international interest rates. [4]

As regards lessons to be drawn for other developing countries, the experience of the Latin American re-entrants clearly points to the potential for a virtuous cycle of higher investment, growth and private inflows. Policy reforms can trigger private sector financial responses which, if well managed, facilitate the broadening of the economic adjustment and reform effort. This consideration assumes an added degree of importance in the context of indications of larger competing claims on world savings and prospects for increased regionalisation – issues that are addressed in Sengupta's paper. [5]

The third layer concerns industrial countries. Here there is need to go beyond the widely accepted principle of a stable macroeconomic environment discussed by Griffith-Jones. Financial market regulators and supervisors face an important challenge: how to meet genuine prudential concerns for protecting the integrity of their financial systems while implementing sufficient regulatory flexibility to (i) avoid undue credit rationing and excessive borrowing costs for developing country borrowers; and (ii) allow market discipline mechanisms to operate effectively.

This is not a new challenge. Similar issues arose in the context of the design and implementation of measures to strengthen the international debt strategy to include market-based debt and debt service reduction instruments for bank claims. At that time, regulators worked closely with debtors and

4 Such instruments are discussed in Mathieson, Folkerts-Landau, Lane and Zaidi, "Managing Financial Risks in Indebted Developing Countries", IMF Occasional Paper No 65, Washington D.C., 1989.

5 See Sengupta's paper "Aid and Development Policy in the 1990s", in this book.

creditors to clarify, inter alia, the application of regulatory rules and, where appropriate, provide guidelines on the treatment of specific issues as they arose. While I do not have time to discuss in depth some of the policy issues that arise in the re-entry phase of the debt strategy, it is worth mentioning five related elements that influence the nature of private market flows to developing countries: (i) the approach to refining procedures of loan-loss regulatory provisioning regimes applicable in industrial countries to bank claims to provide for timely graduation of developing countries with recent debt servicing problems; (ii) the approach to determining risk weights for computing banks' adherence to regulatory capital adequacy requirements; (iii) host country authority over the establishment of financial institutions from developing countries; (iv) use of cut-off credit rating standards for mobilising funds on industrial country securities markets; and (v) actual or implied official insurance schemes covering suppliers of resource flows to developing countries.

Clearly, the objective is to establish the enabling environment in which well-formed market participants allocate resources to activities with the highest risk-adjusted expected returns, while minimising the possibility of disruption to financial markets. Policy analysis and deliberations in these areas are complicated by several issues. First, while there is no strong evidence to suggest that a single factor has contributed, per se, to undue credit rationing or ineffective market discipline, the issue also needs to be approached using a general equilibrium-type analysis – i.e., investigate the extent to which the factors interact. Second, some prudential requirements at the national level reflect agreements on the harmonised implementation of multilateral frameworks – as in the case of the Capital Adequacy Accord. Agreements on such framework are difficult to fine-tune. Third, the approach to bail-out mechanisms for creditors and debtors has to take account of what is essentially an intangible element – contagion effects of financial failures. It is difficult to assess the potential cost of such contagion. The greater the concern for limiting contagion, the larger the likelihood for the de-facto provision of relatively broad bail-out schemes. These considerations must be counterbalanced with the possibility of increasing moral hazard risks, and the related scope for public sector liabilities on account of safety net provisions. Finally, financial markets themselves may be prone to overreaction. Indeed, some observers have expressed concern about the current volatility in bond and equity markets. Such market instability may warrant in some cases somewhat slower regulatory policy relaxation in certain areas (e.g., provisioning and capital adequacy cover). But this is not a costless process. There are trade-offs for the functioning of the international monetary system in terms of efficiency losses associated with misallocation of loanable funds.

Concluding remarks

In concluding, allow me to thank Griffith-Jones for providing a rich documentation of the process of Latin America's restoration of access to private capital flows. Her paper provides a good basis for discussing general policy issues that influence the functioning of the international monetary system. Adequately addressing these issues requires close monitoring of developments and coordination among policymakers in industrial and developing countries. Discussions in this type of forum offers the prospects for strengthening the analytical foundation for meeting the policy challenges ahead.

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Comment on "The Return of Private Capital to Latin America," by Griffith-Jones

Ricardo Ffrench-Davis

Optimism has replaced pessimism for many people in Latin America, as the region has seen notable improvements take place in the past few years, and particularly in 1991. Budget balances have been improved, the printing of money moderated, inflation reduced, and projects better evaluated. But there are also many persistent problems. Private and public investment is low and public wages are far below market levels. Poverty and income concentration continue to increase in many Latin American and Caribbean countries (LACs), to worse levels than before the debt crisis of the early 1980s. Despite clear improvements, therefore, crucial problems remain.

The financial arena has seen significant changes, as documented by Stephany Griffith-Jones in a competent and well-balanced fashion. A large number of Latin American countries have seen a sharp rise in their access to segments of the international capital markets. Foreign savings have become available to them and the region has experienced rapid growth of international financial activity in 1991.

Two questions are raised by this phenomenon, both relevant to developed as well as developing countries:

1. What is happening with overall savings, not only financial savings, but total savings of the world and the national savings of developing countries?
2. How much new productive capacity is being created and what is happening with the rate of use of existing capacity?

These issues must be explored, since financial development is not a gain in itself; it is a means of lubricating and accelerating real economic growth in any country, i.e. increasing investment and productivity, fuelling the capacity to consume, and creating possibilities for higher wage-levels and the provision of productive employment.

In Latin America, the 1970s and 1980s provided examples of both good and bad financial reform. In some cases, increased financial activity was associated with increased economic growth, a rise in investment and better quality of investment. In others, financial reform was connected with diminishing national savings and low rates of investment, along with a decline in the use of capacity. For many years, several LACs operated below the production frontier. That is quite inefficient (see several articles in Ffrench-Davis, 1983), implying that effective ex post productivity is lower than the potential.

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Stephany Griffith-Jones and John Williamson have provided relevant and well-argued insights into these vital issues. But I would like to concentrate on what I consider to be some crucial features of 1991.

I think the fact that Latin America does not find itself in the European financial area, but in the US area is very significant. It is true that world financial markets are becoming ever more integrated, but they are not fully integrated in the sense of having 'one price'. There is a large gap between the price of money in Europe and North America: interest rates diverge widely, and, ex post, the gap has not been closed by exchange rate movements. The external interest rate faced by Latin American countries is not the 9.5 per cent prevailing in Europe but the 3.5 per cent or 4 per cent LIBOR in US dollars. This, and the current low demand for funds in the United States, has important implications for Latin American countries. Both investment and consumer lending in the United States were abnormally low in 1991. This meant that a large volume of funds became available to Latin America and other regions.

Changes in some of the domestic economies of Latin American countries complemented this trend. These included privatisation (in several cases involving a very high rate of return in the short run), low prices for foreign funds, together with high returns in the domestic stock exchange. These have been perceived by economic agents as trends which would continue for some time; combined with low demand in the United States, they generated a remarkable flow of funds towards Latin America.

On the domestic scene, what has resulted? First of all, foreign exchange constraints have been reduced or eliminated. Until 1990, lack of external finance was the dominant constraint on economic activity in several countries, keeping them far below the production frontier.

Since 1991, however, Latin American countries could increase actual GDP faster than their productive capacity, because they had underutilised capacity. So, in spite of low domestic investment, the relaxation of the foreign exchange constraint allowed the GDP to move up. Some countries show increases in GDP as high as 5, 6 or 8 per cent, notwithstanding low investment. Actually, it is not that low investment suddenly became highly productive, but simply that previously the available capacity to generate income had been constrained by a shortage of foreign exchange. But money flows in 1991 have been much greater than the foreign financing actually consumed in the domestic economies of Latin American countries. Thus roughly one-half of the net inflow of capital, totalling $40 billion, has been used to build up reserves.

What does this imply? That the absorptive capacity of domestic economies was limited. Nonetheless, capital kept flowing. Why? Not because Latin America needed more capital for macroeconomic balances, but because short-

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run interest rate differentials or profit rate differentials were wide. So these signals of the market kept drawing capital into Latin America. In such circumstances, what happens? Large reserve accumulation leads to pressures for exchange rate appreciation.

If we look at the 18 main Latin American countries, therefore, we see that in 1991, 15 currencies appreciated in real terms – by between 1 and 20 per cent – compared with the average for 1990. Most of these currencies continued to appreciate during the first half of 1992, in spite of efforts by several governments to prevent this so as to sustain the rise in exports, which was based on low rates of exchange. But the official efforts were no match for the effects of the markets.

Added to the market's influence, there was the justified concern with reducing inflation. When you have a large inflow of dollars, and the day-to-day market is pressing for appreciation, it is hard to supersede this short-run market trend because it contributes to reducing inflation. The most relevant question we should ask, however, is: how much of this appreciation is a movement towards equilibrium or away from equilibrium?

One could argue, following Stephany Griffith-Jones, that part of this might be a movement in the correct direction. Obviously, the debt crisis of the 1980s led to significant real depreciations, which were needed after the appreciations of the 1970s, when abundant and cheap bank loans had caused most Latin American currencies to appreciate. In the 1980s, the trend was reversed, and sharp depreciations resulted. Chile, for instance, more than doubled the real exchange rate between 1982 and 1986. In both decades, there seems to have been an overshooting (from a long-run perspective) of exchange rate adjustments, dictated by short-run policy needs.

At the present time, therefore, there is some room for appreciation without the danger of future imbalances. However, following Stephany Griffith-Jones and Mohamed El-Erian, one must follow with great care how this develops in the future. What will happen with current account deficits, with real exchange rates and what will be the response of exports?

For tradeables do not include only exports, but also importables. In 1991, many Latin American countries reduced restrictions on imports, in most cases correctly. But one has to take into consideration what happens in the real economy in order to conduct an efficient restructuring. If a country is appreciating the exchange rate, pari passu, while reducing import barriers, it will be giving two negative signals for import-competing industries which may result in a strong negative adjustment. Every economy will adjust to market signals, but the crux of the matter is that it should adjust in the direction of creating more capacity, of being more productive, of encouraging people to invest more and better. If a country reduces tariffs and appreciates the exchange rate at the same time, it runs the risk that the positive incentives to

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exports are smaller than the negative incentives to imports. Fiction? No, it is the history of the 1970s, of the countries that instituted strong import liberalisation policies together with exchange rate appreciation. Chile and some other Latin American countries provide clear examples. (Ffrench-Davis, 1983).

So, in evaluating the welfare effects of financial flows, it is very important to examine what is happening in the real world, because what matters in the end is the performance of the real world, the effort to produce more with a higher level of efficiency and equity (ECLAC, 1992). Efficient financial markets are crucial to this effort. Now, what to do when a given country or region faces a revived access to capital flows but these new flows are partly associated with recession in the United States and abnormally high returns in Latin American countries? Then, it becomes necessary to manage or influence capital flows in such a way that they contribute to future stability.

Macroeconomic management, and exchange rate policy in particular, are crucial for stability to be sustainable. This explains why several countries in Latin America have been trying to influence, to some degree, the composition of capital inflows, so that they are tied to the (long-term) investment process. The Griffith-Jones paper stresses this. Encouragement should be given to long-term flows associated with the investment process – direct foreign investment, imports of capital goods, and so on.

This is one component of capital movements. Given their volume, it can be said that it is not the part that creates the appreciating trends. These are more closely linked with the short-run flows which result from short-run interest rate or profit rate differentials.

A second element is, and Mohamed El-Erian emphasised this, the matter of domestic surveillance of financial markets. It is true that most of the flows are conducted by private agents. Some people may think, as they did in the 1970s, that this eliminates the risk of mistake. But history proves that this is a gross error; imbalances can be created by both the public and private sectors. Look, for example, at Chile in the 1970s. Chile had a budget surplus and was reducing public sector debt. Nonetheless, the deficit on its current account had climbed to 18 per cent of GDP by 1981. There was a surplus in the public sector, but a deficit exceeding 18 per cent in the private sector. This was the result, among other variables, of wrong prices (an appreciated exchange rate), large supplies of loans by banks, and generalised myopia on the part of lenders and borrowers.

The surveillance of domestic capital markets needs a rebalancing, and several of our economies should be subjected to careful monitoring, with more emphasis on keeping close track of the quality of the performance of the financial markets. Some countries have been very careful and tough on this matter. In others, part of the job is pending.

The other element is macro-management: how to conduct this so that the capital flows don't disturb the performance of the real sector, especially via their influence on the exchange rate. Here, I think, there is an unavoidable trade-off: we have to choose either to regulate the exchange rate and exert some control on short-run capital movements, or to let the capital inflows determine short-run exchange rates and then go through more radical shifts in the balance of payments and macroeconomic cycles. History, and present events, very clearly signal that one has to make a choice.

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Floor Discussion of the Griffith-Jones Paper

Is Latin America's boom sustainable?

History has taught us, Shahen Abrahamian observed, that financial markets are prone to cycles of boom and bust. Is the euphoria over Latin America's recent return to western capital markets justified therefore? A note of caution could be found in the very site of this discussion, where the notorious 'tulip mania' had once almost bankrupted Holland's economy.

"At the end of the seventeenth century," Abrahamian reminded the gathering, "Holland was the scene of the first great speculative craze in Western European history. It was a purely private, market-driven phenomenon. There were no Keynesian policies, no import substitution policies, no planning involved; it was a globalised, integrated market economy much more so than today. And this tulip mania nearly bankrupted the whole economy."

Today's capital flows to Latin America should therefore be carefully looked at in terms of sustainability, he argued. The sources of these flows – $40 billion in the last year alone – had still not been adequately explained. He felt that the new money gushing into the region was simply being pulled by high interest rates and the expectation that these high rates would be held up.

"Money is coming in because the exchange rate is going to be held up," he contended, "and the exchange rate is being held up because money is coming in. This is a recipe for a bust, quite clearly!"

Other participants shared this fear. Tom de Vries pointed to the strong link between US monetary policy and capital shifts to Latin America.

"When US interest rates were low in the 1970s," he observed, "bank capital flowed to Latin America; when US interest rates became high in the 1980s, capital stopped flowing; and now, when US interest rates in real terms are about zero, capital has started flowing again." Private banker Frans van Loon, saw it differently. The explanation, he said, lies in "the growing efficiency" of the Latin American financial markets.

"In the day-to-day perspective of banking," he said, "the resurgence or improvement of efficiency in banking business – in terms of what is being done with domestic savings, with payment systems and with allocation through the banking system – in Latin America is very notable." According to Van Loon, one has to look at the new flows in the context of the

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complementary capability of the domestic money and capital markets.

"It is only through the improvement of those markets that international capital transfers can play their proper role," he argued. He also pointed to a completely different reason for bankers' interest in the 'newly-emerging markets': the 'lousy situation' in the financial markets of the industrial countries.

"Business in the OECD itself, in the supposedly efficient markets, has not been all that attractive," he said. "Margins have been very low, and there have been very serious debt problems. Banks haven't really gone bankrupt because of the debt crisis in the developing countries; they have gotten into trouble because of huge problems with real estate, agriculture, tycoon lendings, things like that, in the industrial countries. The real big scandals, difficulties and inefficiencies in the financial world in the past years have not been in the developing countries, but in the OECD: the savings and loans crisis in the United States, the collapse of Japanese brokerage firms, the BCCI scandal, etcetera. That's where the real big losses in the financial system have been actually incurred."

Stephany Griffith-Jones welcomed the search for additional explanations of the capital flows into Latin America because she, too, was anxious about their sustainability. "In particular," she said, "I think of the very large privatisations, large increases in stock exchange and prices of shares, and in general the whole area of development of private capital markets that Van Loon talked about. I think this is also interesting because it gives us a hint that some of these flows may be once-and-for-all flows, for example the private flows linked to massive privatisation processes in the last years in Argentina; a lot of money came in to take advantage of that. Some of the foreign direct investment flows, related to creation of new capacity, may turn out to be more sustainable."

Separation of 'good' from 'bad' flows

There was general agreement that some flows are good, while others are less desirable. Ariel Buira emphasised that one should look where the money goes, make sure that the new flows are not used to finance budget deficits, and find out whether the private sector receiving the flows allocates them in a productive way. The difficulty however is: how to separate the good flows from the bad ones.

This poses a dilemma, Shahen Abrahamian noted. To get good flows in, one needs liberal, market-friendly policies, but to keep the bad ones out, some interventionist measures are required. Griffith-Jones thought this problem could be solved by separating them adequately through indirect instruments such as taxation, reserve requirements, etcetera. But going beyond that, she

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warned, is very complex because you end up giving misleading signals and trying to control the over-reaction of financial markets.

Other participants countered that any form of government intervention would hinder "good" money flows. According to Mitsuhiro Fukao, Japan provided an example of this.

"Right after the war a small company called Sony tried to get the transistor technology rights," he related, "but the Japanese Ministry of International Trade and Industry (MITI) held up the approval for some time, because they thought it was a bad project."

Griffith-Jones dismissed this example. She argued that the intervention policy of the Japanese Ministry of International Trade and Industry had greatly contributed to the economic success of Japan. "Japanese government intervention could be an example for other developing nations," she insisted.

Ariel Buira agreed that intervention may be opportune, for instance, in keeping bad flows of money out. An example was the Mexican central bank's policy of discouraging very-short-term flows or 'hot money' coming in.

"We do this by widening the band for exchange rate fluctuations," he explained, "so that they don't know at what rate they will come out after two or three days and that may make it uninteresting to come and arbitrage the interest rate."

Buira cautioned that this strategy was of questionable effectiveness. He said central bank officials from Spain had repeatedly told him that, in a largely integrated market, measures can only limit capital inflows for a short period of time. "After a while, the market finds ways of getting around your measures. The Spanish experience tells us there isn't really much you can do to stop it, which brings us to the question of the need for better government supervision and regulation that Griffith-Jones brought up."

Jack Boorman, amongst others, stressed the importance of letting the market itself do the job of separating good and bad flows. According to him, default and failure are the natural separating mechanism.

"The point is," he said, "that in a world of micro-lending to a diversity of entities, if risk is being priced right, there ought to be failure. We should not prevent failure, for it is a very healthy feedback. More failure, more losses in the US banking system would have woken people up a lot earlier, and the same thing is true for Latin America: failure would be healthier than government supervision."

However, many participants felt that market forces and failure alone were not sufficient. They pointed out that private borrowers and lenders today remember that when things turn out bad in the end there is always the government to bail you out. So they don't take all the risks into account when considering the transfer of capital. Gerald Helleiner suggested, therefore, that capital flows should be subjected to monitoring and surveillance in a

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similar way as is done with money flows related to the drugs trade. He felt there was now a "vacuum we no longer can afford".

Agreeing, Henrik Fugmann proposed that this vacuum be filled by a better supervisory framework. Private banker, Van Loon, supported this view, noting that there was a dangerous gap between the lending and securities business.

"For every loan to a Latin American country," he observed, "we must keep a good portion of our loan as reserves, but if bonds or equity are bought, there is no such requirement." Further control and supervision should not just be addressed to the banks only, but to the whole system of international financial transfers, he argued.

Need for information and guidelines

There was general agreement that the markets should be made to work better and do their job properly, through improvements in the exchange of information on the risks involved in transferring capital to certain countries. Stimulating the availability of "real, reliable open information" was, in Van Loon's view, the best way of improving risk calculation. Present-day information technology makes it easy to exchange information quickly and amply, he noted. But, while recognising the role of monitoring and surveillance systems, he warned against their prominence being increased. "Millions of micro-decisions can do a better job than a few centralised supervisory entities," he said.

But, John Williamson pointed out, while agreeing with Van Loon's general proposals, there is also the need for some macroeconomic guidelines by which such information can be judged. Policymaking cannot be left to a "million" private micro-decisionmakers. "Governments do have an advantage in thinking about macroeconomic questions," he noted, "because that is what they are paid to think about. One shouldn't just leave it to the market, because individuals there make money by spotting a trend before others do, and they don't take macro-sustainability into their considerations."

Clearing up the old debt

Giovanni Andrea Cornia raised the question of what was happening to the old debt and asked what influence the new flows were having on current debt reduction strategies. He felt that old debt had not yet been effectively reduced.

Van Loon countered, "The large scale securitisation of the old debt – all the Brady deals – has been one very important stimulus to the capital markets' activity and particularly the securitised lending that we see now in

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Latin America." Although Griffith-Jones shared Van Loon's view, she agreed with Cornia and the others concerned about the large debt overhang still troubling a number of developing countries. As Drag Avramovic pointed out, "there are 120 indebted countries who still can't borrow." Observing that, unfortunately, Griffith Jones' analysis was not applicable to most other parts of the world, Percy Mistry challenged the notion of the globalisation of the world financial system.

"The global system has fractured itself into three North-South zones, a dollar zone, an ecu-deutsche-mark zone and a yen zone," he stressed. "And there are parts of the world which are not really articulated within any of these. Africa for instance has become part of the charity zone, not part of the ecu-deutsche-mark zone. When we talk about globalisation of the monetary system and of the international financial markets you have the distortion that 150 countries, not 120, have just dropped off the map."

John Williamson argued that these 120 countries might not be such a big issue if India and China were not among them, since both those countries, containing huge sections of the world's population, were "on the wing of market-creditworthiness."

Griffith-Jones had focussed on Latin America, she explained, because that was where the most rapid changes were taking place. But, she said, "perhaps one should have another conference on the poorer countries and their problems, and how they relate to the monetary and financial issues we are discussing."

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Aid and Development Policy in the 1990s

Arjun Sengupta [1]

I have written a paper on aid and development policies on the assumption that an international monetary system must have, as an integral element, policies regarding development and resource transfers stemming from aid flows.

There has been an upheaval in economic thinking and policymaking in most developing countries in the last few years. Nearly two thirds of them have recently adopted adjustment programmes, supported by the IMF, World Bank and other international agencies. They are trying to get integrated into the mainstream of the world economy by adopting more liberal, market-oriented policies. But the history of such efforts is full of examples of failure: sometimes, unforeseen shocks have pushed reform programmes off track, often exports did not increase as projected, nor did aid materialise as promised. The developing countries therefore have argued that, when they adopt radical adjustment programmes in consultation with the international financial institutions, the industrial countries should supply the required help in cash, credit and market access.

Aid and development policy should take into account the revolutionary changes in the world economic and political system which have followed the collapse of the Soviet Union and the end of the Cold War. Its approach should be reoriented to supporting the structural transformations taking place in developing countries. There is now a widespead recognition that market forces should be allowed to operate freely both within and across national boundaries. Governments have realised that the regulation of prices, investment, trade and exchange or restrictions on the movements of goods and services, and of factors of production, usually result in a substantial loss in welfare. There is also a rethinking about the role of the state in economic activities, about central planning, policy coordination and the state's ability to influence the evolution of the economy.

As a result of this almost universal shift of policy towards liberalisation, most economies are becoming increasingly globalised. They are being integrated with each other, not only through the interdependence of trade

1 Abridged version of a paper presented to a Workshop organised by the Forum on Debt and Development held in The Hague on 9-10 June, 1992. The comprehensive paper can be obtained from FONDAD.

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and financial transactions, but also through expanding interlinkages of production and investment as well as marketing and technological tie-ups. For the developing countries, opening up to global competition and becoming integrated into the mainstream of the international economy, rather than operating on the periphery, would place them firmly on a sustained path towards growth and development. The pre-condition for that however, would be that they adjust their economies rapidly to the requirements of globalisation. In the new world of the 1990s, the main objective of aid and development policies should be that of helping developing countries to integrate into the global mainstream. This would imply assisting them in implementing programmes of domestic economic reform, and creating the trade and investment environment for them so that their development efforts can be sustained through increased resource flows and foreign exchange earnings. At the same time, the aid and development policies will have to continue to serve their traditional objective of supporting the long-term development goals of building infrastructure and financing social projects.

I. THE OBJECTIVES OF AID AND DEVELOPMENT POLICY

The objectives of aid and development policies of OECD countries have been quite diverse, depending upon their historical and contemporary commercial and political ties with specific developing countries. They have also been guided by their perception about evolving international relations. In general, however, until recently, their objectives could be summarised under three broad headings: (1) military and political considerations; (2) concerns about social justice, poverty alleviation and human development; and, (3) mutuality of interests. Most of the OECD countries channelled their assistance bilaterally as well as multilaterally, in the form of either financial assistance and technical support or trade concessions and market access.

Military and political considerations

The military and political considerations were directly related to the bipolar division of the world, when the superpowers were trying to build up alliances across their borders with countries in the Third World. With the end of the Cold War, the motivation for military alliance may have disappeared, but the ramifications of power politics have not, and the promotion of spheres of influence with economic and commercial assistance remains an aim of development policy for many OECD countries. The special relationship that the European Community has with the Lomé countries is an example of

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nurturing a sphere of influence without any military alliance.

Recently there has also been a tendency towards forming regional economic blocs. This new development is motivated partly by the interests of trade and enlarged access to markets, but more so by the political considerations of alliance, ethnic affinity and prevention of a possible flow of unwanted immigrants.

As long as the political considerations of the old or new variety keep influencing aid and development policies, it may not be possible to achieve the best distribution of aid and the optimal application of development policy, serving the objectives of development and integration of the developing countries into the global economy.

Social justice and human development

Concern about social justice, poverty alleviation and human development have traditionally been the most important motivation of the aid and development policies of the industrial countries. The policies of assisting the poor, whether at home or abroad, have been inspired in the industrial democracies by a sense of altruism and charity and a respect for the values of justice and equity. While there is now growing pressure in industrial countries to cut expenses and to let the market forces decide among a number of alternative sources of the delivery of welfare, the principle that the richer sections of the population should take on the burden of meeting a substantial part of the basic requirements of the poor has been almost universally accepted.

The aid performance of most OECD countries has fallen far short of the target of 0.7 per cent of GNP as specified in the United Nations resolution. But this should be seen in the context of the steadily rising public expenditure in most of the OECD countries during the last two decades and the increase in competing claims on public funds from domestic sources. The shortfall in aid delivery should therefore not be explained in terms of a general apathy towards social justice and equity, but rather in terms of a failure to persuade the electorate about the effectiveness of foreign aid in promoting social justice abroad.

Mutuality of interest

The traditional arguments for mutual interest are basically related to (a) trade and supply of commodities (b) expanding markets for manufactures and (c) widening the scope of profitable investments. However, industrial countries generally chose to reduce their dependence on imports of commodities and raw materials from the developing countries and to expand their trading and

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investment activities within the industrialised part of the world. The paradigm of mutual interest thus remained an unrealised driving force behind aid and development policies.

In the altered context of the 1990s, when the developing countries are pursuing economic reforms and structural adjustment, the argument of mutuality of interest would seem to have gained a new lease of life. For, if the developing countries follow appropriate policies, and successfully adjust their economies to achieve a sustained rate of growth, a partnership with them could be highly beneficial to the industrial countries. Commodity supplies could be stabilised through increases in their productivity with the injection of both domestic and foreign investment. With a large population, expanding growth, increased capital formation and an improved functioning of the infrastructure in these countries, their potential as markets for exports and profitable outlets for investment from the industrial countries would expand enormously. As these countries develop and build up their industrial complementarities with the countries in the North, they could become extremely effective partners through joint ventures, sub-contracting and production linkages within the same industry. In other words, developing countries that have, until recently, been looked upon only as markets for the exports of the industrial countries, could now be the sources of imports into the industrial countries, thus providing a large scope to the profitable operation of multi-national enterprises.

Of late, environment has come up as another source of mutual interest between the industrial and the developing countries. The scope of the mutuality of interest in this area is so vast that a larger international programme of aid and transfer of resources can be built just upon the possibility of environmental cooperation.

II. THE DESIGN OF AID AND DEVELOPMENT POLICY

Given the objectives of aid and development policies in the altered world of the 1990s, their effective implementation would depend very much on their design, and the way they are actually applied in a specific country. The elements of that design would, of course, have to be flexible and varied, to accommodate differences in the objective conditions in the different countries, such as levels of development, and the nature of the social, legal and political infrastructure. The relationship between the beneficiary and the donor countries, its history and the perceptions about its future, would also influence the framing and the application of these development policies. Nevertheless it should be possible to design a basic structure for such policies, which different donor countries might follow to help beneficiary

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countries in implementing economic reforms, becoming integrated into the mainstream of the world economy and launching themselves on a sustainable path of development.

Conditionality and reciprocal commitments

The most important basis for such a design would have to be a credible commitment by the beneficiary countries to economic reform, involving some sort of conditionality. Although most of the bilateral assistance for development so far has not been linked to any explicit conditionality, it is high time that developing countries realise that without some conditionality they can no longer expect any significant flow of assistance. There are too many conflicting claims on the limited savings of the industrial countries, and there is very little leverage left for developing countries to extract development assistance without demonstrating their ability to use that assistance effectively with appropriate policies.

There already exists a vast literature on conditionality and also a long and varied experience of its implementation by the IMF, World Bank and regional development institutions. We do not need to go into these issues in any great detail, except to point out three aspects which are relevant for the formulation of the new development policies. First, conditionalities should be related to some form of monitoring of the fulfilment of commitments of the beneficiary countries, and not to the actual achievement of their objectives. Secondly, conditionalities cannot be used as a rationing device for development assistance, for harsher conditionalities do not mean greater effectiveness in the use of assistance. Thirdly, the commitment to carry out the adjustment programme will be improved if the developing country receives sufficient external finance.

Since a typical developing country is a combination of different sectors at different levels of development with different types of problems, and the aid and development policy has a number of objectives, it is almost impossible to identify ex ante, a set of policies that would be sufficient to ensure success. Most of the time, the policies would have to be flexibly applied, modified and improvised in the evolving situation of an economy. The best one can expect from the authorities is that they remain committed to following the right policies and maintain the strict fiscal and financial discipline that is necessary to avoid any waste of resources. Therefore, conditionalities for a particular country should be centred around a few indicators that would reflect the country's adherence to those disciplines, such as the reduction of fiscal deficits, or control of money supply, or financial and physical deregulation. The indicators must be sufficiently strict to demonstrate the commitment of the authorities, but at the same time they should be

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reasonably phased to be implementable without disrupting the political system.

The idea behind using conditionality mainly for monitoring the commitment of the policymaking authorities, and not necessarily for monitoring the implementation of an elaborate policy programme, is quite simple, though not always generally appreciated. It is often forgotten that the implementation of an adjustment programme is in the interest of the countries themselves. They would usually stick to it if it is perceived as appropriate. It may be necessary to change an adjustment programme, with the help of external agencies and experts after a full discussion. But it is not necessary to impose the compliance of the country to the programme by monitoring the details. If the commitment of the authorities can be monitored and ensured, compliance to the best implementation of the programme would also be ensured.

The prospects for compliance to the policy commitments of a developing country would improve enormously, if it is assured of all the assistance required for implementing reform programmes. This third aspect of conditionality mentioned above has a special relevance for aid and development policy of the 1990s. Conditionality, especially for the IMF programmes where it has been originally applied, involves a form of reciprocal commitment. If a country undertaking a financial programme fulfils its commitments, the Fund is supposed to automatically disburse the sum it has committed for payment. The Fund's commitments are based on an assessment of the amount of external finance that the country would require, after taking into account all other sources of finance, to implement the programme. With the passage of time and global shortage of transferable resources, especially in the 1980s, this aspect of reciprocal commitments, implied in the conditionality of the Fund programme has been increasingly diluted. The Fund's own resources have proved to be inadequate and, with growing arrears in its repayments, it has been forced by its major shareholders to drastically limit access to its resources. A commensurable amount of resources have not been forthcoming from other bilateral and private sources, in spite of the Fund's efforts to play a catalytic role. As a result, the Fund's programmes have either remained underfunded with unfulfilled financial assurances, or have had to be unduly tightened with a severe compression of expenditure, leading to a contraction of output, employment and living standards.

If the objective of the aid and development policy of the 1990s is going to be helping the developing countries to adjust their economies through structural reform and integration into the mainstream of the world economy, the industrial countries must restore this reciprocal element to the conditionality. If a developing country launches a programme of economic

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reform, it should be assured of all the financial, technical and structural assistance as well as market access and developmental support needed for a successful outcome of those reforms. If these assurances are not forthcoming, the developing country cannot be expected to carry out the reforms and structural adjustment and comply to the stringency of financial discipline except for a limited period. The hope that the success of the reforms would improve the country's credit rating and eventually increase the inflow of private funds is so tenuous and uncertain that unless the reforms produce positive results in a very short period, the contractionary effects of an adjustment programme may force the authorities not only to interrupt the reforms, but also to adopt policies of short-term relief that could be highly counterproductive in the long run.

Market access

Once a feasible programme of reform has been worked out and a set of minimum conditionality accepted by a developing country to demonstrate its commitment to implementation, the industrial countries could reciprocate along the lines of new aid and development policies in the following three ways. First, they could ensure free access for the reforming countries' exports to their markets and provide all possible financial, technological or promotional assistance to build up the export capability of the developing country. It is important to note that all programmes of structural adjustment and market reforms of a developing country imply a reallocation of resources, facilitating increase in export production. These programmes cannot be successful if, at the same time, a stable and expanding market for the exports of this country is not created. Furthermore, such markets should be stable with a reasonable certainty of access and potential for growth, so that these sectors can attract an increasing amount of investment from both domestic and foreign private sources. Given the size of the market of the industrial countries, such a policy would be beneficial even with a small growth of the GNP of those countries.

The ideal policy would be for the industrial countries to provide completely free access to the exports of reforming developing countries, without any restrictions or sectoral limitations. The welfare of the industrial countries can only increase as a result of granting such freedom of access, even if it is completely unilateral. Their imports will be cheaper, real incomes will be higher and resources released from industries losing out in the competition with the developing countries, can be absorbed in other, more efficient, industries, especially with their growing real income. The success of economic reform in the developing countries would create the potential of an expanding market for exports of the industrial countries in

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the immediate future, making the case for granting unilateral free trade access a strong one. The interests of labour and capital which would benefit from those newly-opened markets would not necessarily be the same as those displaced by competition from imports from the developing countries. If the authorities of the industrial countries can make the arrangements to accomodate the displaced labour and capital, there is no reason why free trade access should not be provided to some selected developing countries.

The existing GATT provisions have allowed some members, such as the European Community, to provide preferential treatment to its associates by giving free trade access in return for a promise of opening the markets of these associates, selectively, over time, and differentially, among sectors. Similar provisions can be invoked if industrial countries decide to extend the privileges of associateship to specific developing countries which have undertaken credible programmes of adjustment and reforms. This would not go against the spirit of the GATT.

Alternatively, the industrial countries may adopt the Generalised System of Preferences (GSP) route, by enlarging GSP to selected developing countries undergoing adjustment. To make this policy an effective means of supporting the reform efforts, without introducing market distortions, this enlargement of preferential access should be stable, certain and transparent. It should be free from quota restrictions, subject to simple and uniform domestic value addition requirement, and extended universally to all exports from these countries. It is important to emphasise this point because any attempt to restrict the GSP, either in terms of quotas or sectors of products, would distort the export markets of these developing countries and might give altogether the wrong signals to investors, thus frustrating the objectives of deregulation. Similarly, such GSP should be extended to Non-Tariff Barriers, which have turned out to be, in recent times, the most harmful barriers to trade. The Non-Tariff Barriers, because of the uncertainty of the time and the extent of their application, may often prove to be the single most important disincentive for investment in the export sector of developing countries. A GSP for Non-Tariff Barriers can go a long way to removing that disincentive for a reforming developing country.

The European Community is trying to integrate its own members through a policy of free trade and unrestricted movement in goods, services, capital and labour, with structural help to build up the competitiveness of its weaker sectors. It has extended this policy of integration to several countries outside the Community, by granting them associate membership. To the East European countries, it has offered gradual trade liberalisation, technical assistance, financial aid and technology transfer. Those countries, in return, would have to adopt economic reform policies, so that they could become effective partners. A logical, further step in the Community's

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development approach would be to confer similar privileges to the reforming developing countries. In this way, the Community could become the most helpful partner in their process of adjustment and integration into the world economy.

Balance of payments finance

The second element of the reciprocal commitment in the new aid and development policy I propose, is related to providing adequate balance-of-payments finance to meet the resource gap of a developing country undergoing an adjustment programme. These resource gaps are estimated as a difference between the import and other foreign exchange payment requirements and export and other foreign exchange earnings of the country during the adjustment period, over and above the regular inflow on capital account. Since import requirements are projected on the basis of growth of output and consumption, as well as the time required for completing the process of adjustment, the quantum of the resource gap becomes dependent upon the targets and the design of the programme. If there is an assurance from donor countries and international financial institutions of adequate financing, the programme can be so designed that the consumption standards are not unduly depressed, and that the growth of output and employment is maintained at a satisfactory level, without unleashing inflationary pressures. The prospects of its successful implementation improve not only by facilitating smoother adjustment of economic activities but also by increasing the political acceptability of the consequences.

There is another aspect of such an assurance of adequacy of financing which is related to the occurrence of unforeseen contingencies. Quite often changes in exogenous factors, not taken into account at the time of the formulation of the programme, produce such an adverse impact on the economy of the adjusting countries as to disrupt the process of implementation until new arrangements are put in place. If the industrial countries fulfil their assurance of adequate financing and adjust the quantum of assistance to meet contingencies, reform programmes can remain on track.

Social expenditure finance

The third element of the new policy would be related to maintaining the flow of external assistance required for carrying out the minimum expenditure on social and development infrastructure, and providing additional safety-nets for ameliorating the conditions of social groups adversely affected by the programmes. It is important for the success of any adjustment programme, whether for a sustainable stabilisation or for structural reforms, that social and economic infrastructure facilities are maintained at a reasonable level. For most programme countries with an inadequate supply of external resources, these are the areas where the expenditures are usually cut substantially and often in an ad hoc manner. These involve anti-poverty programmes, retraining, maintenance of essential food supplies, etcetera. An assurance from the donor countries to provide resources to maintain these expenditures would help in avoiding such cut backs. Short run adjustment measures have the maximum chance of success if they complement the long term measures for development on economic, social and human infrastructure.

Development Compacts

If there is general agreement among industrial countries about the elements of the new aid and development policies in the 1990s, as described above, there would still remain a problem of institutionalisation of their application. First, there would be the problem of how to design and set up conditionality in an objective manner, guided by the requirements of the circumstances and not by the political interests or the bargaining strength of the donor and the recipient countries. The simplest solution to this, without creating any additional institutional mechanism, would be if these were left to international financial institutions to discuss and settle with the concerned developing countries.

Fortunately for this new approach, most of the developing countries in the recent period have entered into negotiations with the IMF and the World Bank and subjected themselves to their discipline. By 1993, it is estimated that almost 90 countries would have adopted adjustment programmes of the IMF. Other international agencies have also been active in designing and supporting adjustment programmes for many of these countries. It should not, therefore, be very difficult for the industrial countries to apply their new aid and development policies as an extremely important complement to the adjustment exercise of these international agencies, without trying to decide separately on the design of the programmes and conditionality.

Even after this, however, there would remain a problem of finding a method by which the industrial countries can judge the adequacy of supply of resources and other development policies related to market and technological access for the reforming country. They also have to decide about the burden-sharing among themselves of the cost of these aid and development policies. It is in that context that we may like to consider a proposal of 'Development Compact' between a developing country undertaking a programme of adjust-

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ment and a group of industrial countries providing the necessary help.[2]

This notion of Development Compact is much more modest than other proposals of 'Development Contracts' made by Mr. Stoltenberg of Norway. These Development Contracts are supposed to be comprehensive long-term commitments by the industrial countries, not only for stabilisation and adjustment, but also long-term development, with a provision of international assistance to help the implementation of broad development plans of the Third World countries. Stoltenberg did not specify the details of his proposal for Development Contract which have been, in some sense, provided by Gerard Adams [3] where he talks about a continued dialogue "in the framework of a new institution, a Development Commission which will deal with the specifics of the policy, monitor performance, and supervise the required revisions".

Our notion of a Development Compact is much looser than a formal agreement, but based on an understanding between the adjusting countries, international financial institutions like the Fund and the Bank and a group of industrial countries. It would be associated with an ongoing Fund-Bank programme, with their stipulated methods of monitoring, supervision and revision. In a sense, these Development Compacts can be considered as an extension of the experiment of the Support Group exercise, which were conducted by the Fund and the Bank to help some of the highly indebted developing countries who fell into arrears with these institutions.

To get out of arrears, these countries were persuaded to adopt extremely stringent structural adjustment programmes. Since the Bank or the Fund could not provide them with any resources until their arrears were cleared as per their Articles of Agreement, they organised Support Groups of donor countries who pledged to provide the necessary assistance for implementing their programmes. The Support Groups met frequently to examine the reports of the Bank and the Fund about the state of implementation of the programmes, deliberated on adequacy of the programme design, the targets and the conditionality as well as the success or failure of the arrear countries in meeting the performance criteria. On the basis of these deliberations, they decided upon the amount of finance that should be provided to the country under programme, and also the method of sharing the burden among themselves.

The Support Group exercise was performed in an ad hoc manner and there

2 Sengupta, Arjun, "Multilateral Compacts Supporting Economic Reform", to be published in the Companion Volume to the Report of the South Commission.

3 OECD Development Centre, "Towards a Concept of Development Agreement", Technical Papers No. 43, Paris, August 1991.

was no systematic approach to an aid and development policy as elaborated above in place at that time. If, however, there is now general agreement about the tenets of the new approach which we have elaborated, it should not be difficult to institutionalise the Support Group mechanism in the form of a Development Compact. It would not require the creation of a new institution, because, for most of the developing countries, there is already a mechanism of consortium of aid groups, from which a number of industrial countries may be selected to form a Support Group when the country concerned agrees to adopt major adjustment and reform programmes. It would not take much time for this mechanism to come into full operation because it can always use the experience of the existing Support Groups.

III. RESOURCES FOR AID

The success of the new aid and development policy for the 1990s would depend very much on the amount of resources industrial countries would be willing to transfer to developing countries. Development policy related to trade and market access may not immediately involve any net resource transfer, although, eventually, some funding may be necessary if assistance is provided to build up the export capabilities of the developing countries. If the capital and skill formation, implied in the building up of capabilities is financed by grants, it would obviously imply a net resource transfer. If they are provided by private foreign investment or commercial and official credit, there may be an immediate resource transfer that will be compensated by future outflows of dividends, interest and amortisation, whose present value would generally exceed the amount of the immediate resource transfer.

However, in many cases, these flows of investments and credits may have to be promoted with tax concessions and holidays or concessional interest, in which case, again, there would be a net resource transfer. To this, one should add the possible use of structural assistance given by the authorities in the industrial countries to their domestic industries facing competition from the developing countries who are granted free market access. Although this flow of assistance is confined to the domestic economies of the industrial countries, it may be reckoned as a necessary resource cost of following the new policy.

So the new aid policy as described in this paper would imply a substantial additional resource transfer. To the traditional use of development aid, we have added financial flows to provide the assurance for meeting the resource gap in an adjustment programme, together with the amounts needed to meet the unforeseen contingencies, as well as to provide the safety net to the vulnerable groups affected by the programme. This might require a substantial amount of resource transfer, depending upon the number of countries accommodated and the length of the programme period during which export earnings and normal capital flows are unable to meet the demand for resources. We should therefore try to identify the potential sources of additional aid.

An immediate implication of the end of the Cold War is the possibility of a reduction in military expenditures, and the likely emergence of the "peace dividend". The Human Development Report of 1992 has identified the possibility of raising $1,500 billion by the year 2000, if military expenditures are reduced by 3 per cent a year during the 1990s. $1,200 billion out of this would come from the industrial countries and another $279 billion would come from the developing countries.

Even if such peace dividends do not materialise to this extent, there would still be a very large scope for generating a large surplus of resources in the industrial countries by a small increase in their rates of savings. The Human Development Report has presented the statistics about global economic disparities which show that the countries accounting for the poorest 60 per cent of the world population had a total domestic investment of less than $300 billion in 1989, which was between 8 and 9 per cent of the total domestic savings of countries with the richest 20 per cent of the world population, amounting to more than $3,500 billion. Assuming that these rich countries have a rate of savings of 22 per cent of GNP, which is the OECD average, only 1 per cent increase in their savings rate, transferred to the poorest countries, could increase the rate of investment of the latter by more than 50 per cent.

This arithmetic indicates the relative insignificance of the magnitude of aid compared to the total claim on resources. The combined GNP of the countries with the richest 20 per cent of the world population in 1990 would be more than $17,000 billion. The official development assistance received by all developing countries in 1990 was roughly $44 billion. An additional saving of a little more than a quarter of one percent of the GNP in the richest countries, if transferred to the developing countries, would more than double the aid flows to these countries to about $90 billion a year.

The diminishing utility of income

The Human Development Report of 1992 has used an ingenious method of adjusting the per capita GDP of the richer countries, in terms of the utility of income, where that utility reflects the well-being of the people, defined as human development. As a country's income per capita increases, the marginal utility of income for that country diminishes. This has been described as the diminishing returns for human development in these countries. Any

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additional income contributes less and less to well-being or human development in those countries.

The Report has specified a minimum level of per capita GDP of $4,829 (in terms of the purchasing power parity dollar of 1989) as the threshold income, up to which there is no fall in the utility of income. Most of the countries of the world have per capita incomes below the threshold, implying their per capita GDP increases directly reflect the well-being of their citizens. The richer countries, however, have higher per capita incomes and the increase in the utility of income is therefore less than the level of income. According to a certain formula, the Report has calculated that major adjustments have to be made in the per capita real GDP for the richest countries, to reflect its contribution to well-being or utility. For example for the USA, the adjusted real GDP was only about 25 per cent of the actual real GDP; for Japan it was 35 per cent, for Switzerland it was 27 per cent, for France it was 32 per cent; for the UK it was 36 per cent; for Italy it was 37 per cent. This implies that for a number of very rich countries, 60 to 70 per cent of their incomes have negligible marginal utility, or that they make very little contribution to the well-being of their own people. [4]

If the logic of this argument is accepted, the case could be made to divert, as aid to developing countries, that part of income in the richest countries which yields only a negligible additional utility. If, for example, 10 per cent of the income of the richest countries were diverted as aid, the amount would be phenomenal: as high as $1,700 billion, assuming their combined GNP as $17 trillion.

Resistance to aid

The fact is, however, that there is great resistance in industrial countries today to any move for increasing foreign aid to developing countries. Many people have serious doubts about the ability of the receiving countries to use that aid efficiently. If the new aid and development policies for the 1990s, as spelt out in this paper, are implemented, this problem could be solved. But then there is still the issue of what mechanism one would have to apply to withdraw resources from exactly those sections of the population for whom

4 Although the extent of this adjustment appears to be a bit too large, it brings out the logic of this approach which seems to be quite reasonable. The level of per capita GDP of $4,829, chosen as the threshold, is derived from a Luxembourg study of the levels of poverty in eleven industrial countries, indicating some sort of a poverty line in these countries, below which the marginal utility of income cannot be falling. If this threshold amount is enough to meet all the basic requirements of living, health, nutrition, shelter and education, an income level exceeding this amount could very plausibly add to the total well-being of the population, or the utility of income, but only by a diminishing amount.

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the marginal utility of income is negligible. A marginal increase in the progressive income tax could produce the desirable effect. If taxpayers could be persuaded of the logic of diminishing marginal utility of income, and if the threshold per capita income can be seen as adequate for meeting most of the basic biological and cultural needs of the population, then a marginal tax, progressing with the multiples of that threshold income may find sufficient acceptance to generate a substantial amount to be dispensed as aid.

Thus, industrial countries could incorporate in their direct tax system a new line of income tax for supporting foreign aid so that every unit, whose income exceeds a minimum per capita income that is needed for a decent standard of living, would be liable to pay a marginal tax that would rise progressively with the difference between its actual income and the minimum threshold income. For example, if the threshold income is $5,000 per capita and the tax unit is a family of four persons, it would pay no such tax up to an income of $20,000, and would pay, say 1/2 per cent on income between $20,000 and $40,000, 1 per cent on income between $40,000 and $60,000 and so on. The exact rates and slabs of the tax would depend upon the size of the units, types of exemption and the nature of assessing the tax liabilities in the different countries. But the principle should be a transparent linkage between the actual income of the tax payer and the threshold income of basic needs, on the assumption that the marginal utility of income sharply diminishes as income exceeds that threshold income.

In principle, it should be possible to build up a new system of international tax liability for the richer countries in accordance with the logic of this argument which could replace the so-called uniform target of 0.7 per cent of income for aid applicable to all countries. In fact, if there is an agreement in favour of such an international tax for foreign aid, it can operate effectively by specifying the liability for each country and leaving it to the authorities of the country to amend their own tax systems suitably. In practice, the possibility of generating such revenues will not be easy. The problems is that most industrial countries are running high fiscal deficits and are trying to reduce the level of taxes. So, whenever a pool of resources can be released, there will be pressure to use it for reducing the level of the deficits. Moreover, there is now a general antipathy against raising or operating with income tax in most of these countries.

IV. CONCLUSION

To sum up, and if the above line of argument is accepted, the following conclusions can be reached about aid policy in the 1990s. First, it should be possible, in principle, to identify potential savings in the richer countries which can be diverted to the developing countries as foreign aid at a relatively negligible cost in terms of well-being of the richer countries. Second, appropriate fiscal methods for mobilising such resources can be worked out provided that the authorities in the richer countries follow complementary policies, and that the public at large in those countries is persuaded to transfer part of its income as aid to the developing countries, contributing to the improvement of its own well-being. Third, the way to persuade the public at large of the richer countries to provide such foreign aid would be to make it transparent that these aid funds are being used by the developing countries in areas which promote Human Development or in areas which have the potential of promoting mutual interest. Fourthly, in order that the people of the richer countries have confidence that the recipient countries will make the most effective use of the funds received by them, these aid funds should be used to help them implement economic reform programmes with credibility. When these programmes are implemented within a framework of the discipline of international agencies such as the IMF or the World Bank or other regional development banks, they would appear to be most credible. Attempts to mobilise resources in the richer countries as foreign aid in support of these programmes would then have the maximum potential of success.

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Comment on "Aid and Development Policy in the 1990s," by Arjun Sengupta

Gerald Helleiner

There is much in Arjun's paper with which I can agree, there is a great deal with which I cannot, so I will concentrate on the latter.

Firstly, let all of us be clear, as to where the aid 'problem' is, where it is actually located. To be quite explicit, we are talking now primarily of low-income countries (we may put in India and China or not, depending on our definition), that is, of that part of the world which is being 'delinked' from the globalised system, of which we have been speaking. It is Sub-Saharan Africa, where the events of the past decade have been most serious, where the debt crisis continues to worsen, and where there are really no signs of recovery.

A principal problem for the low-income countries and particularly those in Sub-Saharan Africa, is undoubtedly the underfunding of the programmes to which they are already committed (to the IMF, the World Bank and the donors). When one speaks of 'credible commitments', one has to include donor commitments of various kinds, I don't mean simply the 0.7 per cent target. I mean the quite explicit commitments to individual countries made at the time that they embarked upon stabilisation and adjustment programmes and which have not fully been met.

Secondly, there is the problem of the 'aid relationship', as I.G. Patel called it so many years ago. ('Aid fatigue', by the way, was a phrase that originated in 1969 with the Pearson report, which was also the time that I.G. Patel wrote his famous paper on the aid relationship.) There are serious difficulties, which I think Arjun has glossed over, in the way in which donors and the Fund and Bank interact with a recipient. In low-income countries, particularly the small ones, the sheer transactions costs of dealing with aid donors is significant. But I speak of broader issues which fall under the heading of 'conditionality'. I doubt whether Arjun's focus on policy commitments can be the full story. He will remember Edmar Bacha's proposals to the G-24, at the time when they were working together, that both performance and policy commitment should be relevant. If you can perform without doing exactly that which the donors or the Fund or the Bank tell you, why should donors complain? If you do precisely that which the Fund and Bank tell you and it turns out to be wrong and you do something else, why should you be punished for that? I simply reject the focus that Arjun urges upon us on policy commitment as the basis for the aid relationship and on conditionality.

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The asymmetry of power in the traditional donor-recipient relationship is one which, if I've understood him correctly, Arjun proposes to worsen. The traditional objective of those who sought to ease the aid relationship, is to increase the proportion of the flow which is non-discretionary. If in Arjun's system you grant to the donor the right to provide further rewards for good behaviour in the sphere of trade, GSP or whatever, you open the door to precisely the kind of bullying and abuse which we have seen too much of in the last decade. If your intellectual property laws are not precisely the way they are in the donor country, you are punished! If you don't abide by service industry regulations which are precisely the way someone else says that they should be, you are punished! These discretionary possibilities increase the capacity of the party that is already stronger to punish those who are behaving in ways the donor considers inappropriate.

I still prefer greater automacity in resource flows to low-income-countries, not total automaticity, nobody is suggesting that, but a greater degree than we at present have. We have gone to a shorter leash already. Arjun's proposal is to shorten the leash, if I have understood him correctly, still more, and increase the number of instruments to persuade recalcitrant governments to do the right thing. I should add that the essence of the Enterprise for the Americas Initiative (the Bush Initiative for Latin America), is precisely to reward those who behave appropriately. This is a recipe for further bullying; and I suspect that this is not what the aid recipients would be keen on hearing.

More substantively, Arjun overstates the degree of consensus on his third strand of minimum conditionality. There is no difficulty with the basic macro and fiscal/monetary side; you have to get the macro sums right. However, when one gets into the sphere of deregulation and into the sphere of integrating with the world economy, there is a great deal of room for sophisticated and functional interaction with the international economy and sophisticated and functional – as opposed to ideologically rooted – deregulation. I had thought that there was already in Washington some retreat to a more moderate and nuanced approach to the elaboration of trade policy, policies toward the external economy, and policies on the deregulation and privatisation of the domestic economy. I am afraid I find Arjun's 'deregulation' heading, in the way in which he phrases the argument in respect of openness, a little too crude. I would want to see exactly what he proposes to put under that heading.

I disagree with Ariel Buira that in order to obtain export expansion, it is necessary in general to liberalise imports. It may have been in Mexico. It is not, however, what Korea did. There is an ongoing discussion of the efficacy of alternative ways of liberalising, and the efficacy of selective and targeted instruments in the sphere of industrial and agricultural policy. (Some of the

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instruments are commercial policy instruments, some are in the financial sphere.) Dispersion in the incentive system is not a total disaster in all circumstances, in all places. I would be wary of requiring the degree of uniformity in the incentive structure that seems to be implied in Arjun's demand for increased openness.

One also wants nuances in approaches to the spheres of intellectual property, the services sector, and foreign direct investment. Otherwise one ends, as Canada and Mexico are, with policy convergence with the policies of the major power with which they most interact, regardless whether those policies are appropriate in any sense but that they are required in order to extract reciprocal concessions from the larger power. Fine-tuning of these regulation and openness instruments in general yields rapidly diminishing returns once you have the macro-balance right, once you have the real exchange rate, in particular, right. There is no firm evidence that total factor productivity grows faster with less dispersion, or a more uniform incentive structure. The World Bank's work is continuing on this but it is clearly agnostic thus far; as is some work by a number of colleagues in 17 countries with which I am engaged under WIDER auspices. It is very difficult to find relationships between ongoing productivity change, as opposed to 'one-off' static reallocation, and the trade regime. There may sometimes be some, but it hasn't yet been demonstrated.

What about the reasons for the current aid fatigue? Arjun argues that the problem is not a diminution of social justice instincts and humanitarianism in the industrial countries, but rather a widespread view that aid is not effective; and that if one imposed his conditions – as opposed to allowing countries to develop programmes that they themselves 'own' – the imposed conditions would persuade the electorate that aid would now work. I suspect this is wrong on two counts. Firstly, aid that is imposed, or conditioned (as opposed to locally owned programmes), will not function well. Such programmes haven't typically worked in the past – which is not to say that some identical programmes developed from within may not be highly successful, they have been. Secondly, the reason for electoral discontent is not a perception that growth has not been fast. On the contrary, I think the growth of discontent is at its greatest in the non-governmental organisations, which perceive that the kinds of programmes which Arjun urges, do not address directly the poverty issues and cater to their humanitarian instincts in the way in which they have believed in the past. If we go further in this direction I suspect that the non-governmental organisations will be less enthusiastic about aid, rather than more, and they may well be right.

It is important to underline the distinction that Arjun has made between the provision of assistance to those most affected by adjustment programmes, and the target (which I believe now to be the World Bank's, and certainly

UNICEF's), which is to address poverty directly. These two objectives generate quite different results. I prefer addressing poverty directly, precisely because the political system will generate the heat and the pressure to protect those who are most directly affected, whereas there is nothing comparable to protect the truly vulnerable and poor. If Arjun relies on instincts of social justice – which he believes to be unchanged in the North (I don't believe it is true in the US or the UK or Canada, I don't know the other countries as well). He must realise that those who take that line will not be too happy with the way in which he comes down on that critical distinction. What concerns me most is that the non-governmental organisations, with their humanitarian instincts, are losing faith in the aid process and are very concerned about the nature of conditionality. Future further underfunding could thus be a risk.

In terms of funding, I suspect the earmarking that Arjun suggests in the income-tax system is a non-starter; and I won't want to say much about that.

One last word. I think the world cannot now rely on US leadership. The US political structure has changed. It now emphasises international interests and humanitarianism and social justice less than it once did. There is a particularly cramped and insular US worldview. The US has had the worst or second worst aid record for the past decade in terms of per cent of GNP. It has amongst the worst record of aid flows to the least developed countries. It draws on world savings rather than supplying them, it has a massive amount of external debt. It was a laggard in Paris Club reform for the lowest income countries; it still is, although it instantly turns around, on strategic grounds, for Egypt and Poland. It is holding up the treaties on global warming and environmental diversity in Rio. It held up the IMF quota expansion and held it down when it was finally agreed. It will hold up IDA-10. It delayed the World Bank's expansion of resources. It is the largest in arrears to the United Nations. It has been the strongest unilateral actor or bully, in the trade sphere in recent years.

This is not where one looks for initiatives in this sphere. It is Europe that has the major aid flows collectively. It has the major trade flows as well. There is no need to wait at each step until the US comes on side. There must be some way in which global action can take place in the 1990s and beyond. Action is possible in particular spheres, not in all, which doesn't depend on US agreement, for instance with regard to IDA-10 or the size of the IMF, or SDR issues. There are alternative leaders and/or collective arrangements which must be considered when we have a globe that needs this kind of assistance so much and when the traditional leader is so likely to be inactive.

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Comment on "Aid and Development Policy in the 1990s," by Arjun Sengupta

Henrik Fugmann

Of course one has to be careful in commenting on a paper by Arjun. First, because he is excellent and his very substantive paper is a testimony to that, and second because the rest of us is not easy to convince.

Let me start off by saying that I do not agree with the general attitude that seems to be that any international monetary system should have as an integral part development assistance and aid. The monetary system has its objectives and means, and development policy has its own objectives. Of course those two systems interact, but the more you confuse or mingle the two together the less likely we are to make progress. History has taught us that linking the two systems is not advisable. John Williamson has made that point on the SDR; the development link to the SDR effectively killed the SDR.

I agree basically on many issues and goals in Arjun's paper, but I do not agree with the implicit philosophy and some of his remedies. The paper contains all the right things: he says the right things on liberalisation and market economy, but it still seems to me when you read the paper as a whole, that it is a little bit paying lip service to these principles. I am afraid you are back to the idea of the 1960s of throwing more money at the problems and then hoping they will be solved.

The one issue I definitely agree with is on trade policies and free market access, and it is gratifying that Arjun Sengupta can keep up optimism after four years in Europe.

To come to the support groups or development contracts, this is something which runs counter to a more liberal, more market oriented outward looking approach, and I don't see that it will secure a burden sharing. What it will secure is an even more politicised process than you have seen so far. I don't think you can really compare it to the support groups in the arrears strategy of the IMF, but if you set down the support group like the one you propose now, it will be permanent and much broader, and it will be difficult to keep that together. I am not sure that you will have the best result by sort of regionalising or making groups of that kind.

There is also too little emphasis on the developing countries' own responsibility. You talk about pursuing policies in good faith, and you talk about commitments which have to be monitored and not actual results. You have to do both. Policy commitments are important to monitor because you can achieve certain results by different means and obviously the donors and

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the international institutions should have a say in the means as long as you borrow from them. Also these support groups would be too weak vis-a-vis recipient countries. They have no political backbone, they will dilute the international financial institutions' responsibility whose advice they are going to take.

Apart from the lack of stress of developing countries' own responsibilities it is also, and recent experiences has shown that, of prime importance to get industrial countries to get their own houses in order, because otherwise you will never get the necessary political support to do anything. You have to look at development aid and plans, and structural reforms of the World Bank together with the IMF software, i.e. policy advice, and, to a limited extent, its money. And of course, the process down that road has been started some years ago and more has to be done in that direction. But here we still have the fact that cross-conditionality in some broad sense of the word is still a no-no. Then secondly, and that speaks in favour of support groups or development compacts, the ideal would also be to let national aid administrations coordinate much more closely with the IFIs. But they still want to have their own national flags planted. Also, because there is a movement towards more tied aid it will be very difficult to have national aid administrations coordinate.

Then Arjun is addressing the interesting issue of resources for aid. I think you would have great difficulties in convincing populations in industrial countries that they are in a position of declining margins of utility of income. To the extent that they have any sense of that, it will go for environmental purposes. In Europe, at least, it will also go for Eastern Europe. To try to convince them of the need for an international tax for developing countries is more than difficult. One can also look at the present difficulties in the Community in adjusting fiscal deficits and getting growth underway. The two main topics in Europe are the environment and CIS. It will be difficult in getting any further than that. Arjun may be able, if he stays on in Brussels long enough, to convince the EEC Commission to come up with the proposal for an international tax for that purpose but I am sure the member states will not accede to it.

There is a need to make an even stronger case for concentrating on what you have called the 'silent revolution': the spread of the market gospel, and try to convince politicians that that is what we need. The most important sin of industrial countries is bias in trade, protectionism and bilateralism. Look at the GATT Round and see the US lack of leadership and also for that matter the EEC. In general, the signs of a breakdown of the multilateral system in various areas is the most worrying aspect for developing countries and for smaller developing and industrial countries in general. There is absolutely no leadership at present, even the G-7 does not work in spite of all the rhetoric.

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Finally, on the EEC adopting certain developing countries: you have to have a general liberalisation of trade, multilaterally and unilaterally. The agreements of the EEC with Poland, Hungary and Czechoslovakia are highly inadequate, from those countries' point of view. And we have not been successful as economists or civil servants in convincing politicians of the blessing of trade liberalisation.

It should not be too difficult for the EEC to suggest a few selected developing countries. However, it will be extremely difficult to choose. Spain will look at Latin America to find partners, France will look at certain areas of Africa, the United Kingdom will look at different areas of Africa, Germany has enough in Eastern Europe and CIS, and others will look at the poorer sectors, so I am not too optimistic about that. This is an additional argument in favour of general trade liberalisation.

In my view, we should address two most important issues, namely the lack of political will for international cooperation (which is much more an issue today than it was 10 or 15 years ago) and the tendency of breakdown of the multilateral system.

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Reply to the Comments

Arjun Sengupta

I must say I was quite surprised to listen to Gerry Helleiner's comments on my paper. Admittedly, my paper was rather long, dealing with many issues, some of which were highly controversial and on some my views were quite provocative. Still Gerry could not have glossed over the main point I was trying to make in the paper if he had read it carefully. I am sure that his views have evolved much beyond the rhetorics of the sixties, in which all of us had indulged, at some time or other. He must have also recognised that there is now a much broader consensus about the basic tenets of economic policy whether in the developing or in the developed countries. We now rarely talk about our "own" programmes of policy as against those "imposed" by more powerful countries or by the Fund and the Bank. We argue about the right or wrong policies or appropriate 'conditionality'. We enter into policy dialogues and negotiations and we may have to compromise by accepting not the most preferred option. But we do that out of our own volition and judgement and not because we have to accept punishment from the donor or their "bullying and abuse".

Similarly, when we talk of a preference for deregulation, it is not rooted in any ideology - it is simply a product of experience. I had mentioned in my paper that governments have realised that the regulation of prices, investment, trade and exchange or restrictions on the movements of goods and services, and of factors of production, usually result in a substantial loss in welfare. I also mentioned there is a rethinking about the role of the state in economic activities, about central planning, policy coordination and the state's ability to influence the evolution of the economy. Gerry is clearly uncomfortable with such statements. He talks about "sophisticated and functional deregulation," a "moderate and nuanced approach," "the efficacy of selective and targeted instruments."

Gerry is a respected development economist and he cannot be unaware that we have had quite a long experience of practising "selective", "targeted", "functional" regulation and control guided by the theories of market failure and the governments commanding more information than the private entrepeneurs, and in the process landed ourselves in the current mess.

Gerry's comments on performance and policy commitment also betray an attitude of distrust that the aid-givers and the Fund-Bank are somehow interested in imposing on developing countries wrong policies. If we can

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perform without following the policies prescribed and solve our problems, then either it is a fluke and a result of exogenous factors, which should be no comfort as the problems will recur again, or the policies prescribed are wrong. Normally, it does not happen this way. The policies prescribed are adopted by the developing countries after a good deal of deliberation only after being convinced of their usefulness. Still quite often they cannot perform, because given the state of our knowledge a right policy can be only directionally right in terms of the first derivations of the function, i.e., can be said only as leading to the achievement of the target. A policy X can lead to the objective Y. It can rarely be said that a given amount of X will result in a definite amount of Y. It is a matter of empirical specification of the functional form and very few policy prescriptions in the developing countries are based on any strict empirical estimation of the relationships. That is why I am saying that there should be no insistence on performance in a set of policy conditions attached to the programme, but only a check on policy commitments. The problem then would be to find some proper indicators of policy commitments, and these are not very difficult to find through reviews and monitoring as the Fund has tried in many instances. In any case, it would introduce a significant flexibility in the conditionalities, which I am sure Gerry would welcome.

This brings me to the main point that I tried to make in my paper. I am not opposed to the traditional form of aid for poverty alleviation, human development and the building of infrastructure. But I feel that the case for even that form of aid will be stronger if it can be linked to improving the political and economic feasibility of implementing the programmes of reform that most developing countries have adopted in the recent period. The industrial countries must accept the reciprocal obligation of helping these countries through aid and balance of payments finance as well as improved market access and flows of investment and technology. The case for such reciprocal obligation has to be argued and campaigned for, and although it is rational in terms of increasing global welfare, one cannot hope that it will be accepted easily by all countries.

Mr. Fugmann of course does not misunderstand the main point of my programme. He brings in the old argument that the developing countries need more adjustment and reform and less finances. I do not mind that because it is an empirical point and it is possible to estimate how much finance a developing country would need to carry through an adjustment programme over a number of years. If Mr. Fugmann and his colleagues from the industrial countries accept that they have an obligation to make available the finances required for adjustment, I have got what I wanted and would focus henceforth on designing the appropriate adjustment programmes. But he does not quite commit himself to accepting such obligations and claims that he does not believe that "any international monetary system should have as an integral part development assistance and aid." It probably does not, if an international monetary system is concerned only with the adequacy of international liquidity. But if it is concerned with an orderly growth of world trade, output and employment with price stability, it has to deal with the problems of the developing countries. Those problems, even in the short-run and even when they are limited only to the balance of payments, cannot be abstracted from the provision of finance necessarily linked with their needs of development.

Finally, a few words about my exercise on resources. It has to be looked at in the context of the 0.7 per cent targetry of official development assistance. My proposal of calibrated obligation of different donors is no more unrealistic than the uniform target of 0.7 per cent for all ODA countries. Suppose we are able to estimate X as the per capita income of the ODA countries which can be regarded as sufficient to meet all the basic needs of food, shelter, clothing, health and education. It is quite legitimate to assume that if the per capita income of such an ODA country exceeds X, its marginal contribution to that country's human development, well-being or utility declines. I have used a formulation from Atkinson, as adopted in the Human Development Report 1992, to estimate for each ODA country the amounts by which their nominal income should be adjusted to reflect its contribution to human development or utility. It appears that for most countries the adjustment would exceed 60 per cent. Obviously, this feature would depend upon the form of utility function that has been assumed. It can be much less than that or more, but it does not matter very much for my exercise. Suppose it is only 10 per cent, which with a $17 trillion combined nominal income of the ODA countries would yield $1,700 billion of income with negligible utility. If only 10 per cent of that is transferred as aid to developing countries, and 90 per cent is used for social expenditure in the industrial countries themselves, the aid amount can go upto $170 billion. I am only advocating a tiny fraction of the nominal incomes of the industrial countries to be transferred as aid to the developing countries since that would make a negligible difference in the ODA countries' well-being or utility, leaving enough scope for fulfilling the requirements of the poor of the industrial countries themselves. Accordingly, I have calculated the separate obligations for aid of the different ODA countries, as distinct from the uniform 0.7 per cent target for all of them.

Now it is of course possible that the ODA countries would reject this exercise by suggesting that their welfare functions are such that the marginal contribution to welfare of per capita income does not diminish at all except at a very high level so that there is very little difference between their nominal income and its contribution to welfare. In other words, they would have very

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little to spare for the developing countries without substantially hurting themselves. Maybe it is true, since nobody knows the actual form of their welfare functions. However, I doubt that very much. Looking at the numbers we are talking about, it should be quite possible for the ODA countries to substantially increase their aid without sacrificing much of their welfare.

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International Monetary Reform and the Prospects for Economic Development

John Williamson [1]

This paper discusses what scope exists for reform of the international monetary system to improve the prospects for economic development. It starts by describing what is meant by an international monetary system, emphasising how official arrangements depend on the position of the private sector. The next section assesses the interests of the developing countries in international monetary arrangements. That leads into a discussion of which proposals for reform have been overtaken by events and which look more promising.

I. THE ELEMENTS OF AN INTERNATIONAL MONETARY SYSTEM

An international monetary system consists of three elements. The first is an *exchange-rate regime*, which determines the rate of exchange at which one money is traded for another. Second, there must be *reserves* that can be transferred in settlement of surpluses or deficits when transactions are unbalanced. Third, an international monetary regime also involves *adjustment obligations*, covering both a specification of when imbalances should be adjusted rather than financed and who is to take what action when adjustment is called for.

Official arrangements concerning those three topics are not determined in a vacuum. What is feasible depends critically upon the state of the private sector. For example, in the early postwar years capital mobility was still low. This was in part a consequence of the fact that most countries still maintained capital controls, but it is very doubtful whether a reimposition of capital controls could take the world back to where it was in the 1950s. The fundamental fact is that not many investors were prepared to consider investing outside their home market, and that fact made capital controls feasible. Thus capital controls and a fear of foreign investment were mutually

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1 Revised version of a paper presented to a Workshop organised by the Forum on Debt and Development held in The Hague on 9-10 June, 1992. The author is indebted to J.J. Polak and participants in the workshop for comments on previous drafts.

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supportive: to resort to the former now that the latter has disappeared would invite massive evasion.

As long as capital mobility was low, and speculative capital movements were effected mainly through leads and lags, it was possible to maintain an "adjustable peg" *exchange-rate system*, in which parities were occasionally altered in sizeable discrete steps. As capital mobility increased through the 1960s, and industrial countries progressively abolished their capital controls during the subsequent two decades, this system became increasingly less manageable. An attempt was made to operate a fixed-rate system in the 1960s, but that attempt ultimately collapsed,[2] and the world learned the hard way that it had outgrown the adjustable peg. After a series of severe speculative crises, the major countries resorted to floating rates. When the European countries once again revived a system of pegged rates (the EMS), they kept individual parity changes small enough to limit the incentive to speculate, almost as though they had agreed to institute a crawling peg.

It is possible for the *reserve assets* used by the official sector to be quite different to the assets utilised by the private sector. For example, in the early postwar years most reserves were held in the form of gold, while in most countries the private sector had been prohibited from holding gold except for artistic and industrial purposes. This historical precedent presumably encouraged the international monetary reformers of the 1960s to invent a reserve asset (the SDR) that would be held only by the official sector. In fact, however, this situation is historically unusual. Until 1914 the gold standard had operated with gold being held both as a monetary asset by the public and as a reserve asset by the official sector. And in the postwar period most central banks ultimately concluded that it was more convenient to build up their reserve holdings in the form of dollars; this was what they acquired in intervention when their country was in surplus, and what they would need to sell to the private sector in order to defend their currency if it came under pressure in the exchange markets. Hence the vehicle currencies found to be most convenient by the private sector tend to become the reserve currencies as well.

The state of the private sector also has a profound impact on official arrangements as regards *adjustment*. Capital mobility permits the financing of large current account imbalances; indeed, as long as confidence is maintained, the limit to a payments deficit provided by a reserve constraint disappears. The reserve constraint is replaced by a *creditworthiness constraint*. This tends

2 The attempt collapsed for two reasons. First, it proved necessary to change the exchange rates of countries like Britain to facilitate the adjustment process (given that there was still a reluctance to sacrifice full employment to the needs of the balance of payments). Second, it proved necessary to permit countries like Germany and the Netherlands to avoid importing US inflation.

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to be a much more elastic constraint, which can at times allow countries to go very heavily into debt. The cost is that at other times the constraint can become much tighter, stranding countries with large volume of unserviceable debt, as happened to many middle-income countries when the debt crisis broke in 1982.

II. THE INTERESTS OF DEVELOPING COUNTRIES

How are the interests of developing countries affected by the organisation of the international monetary system?

Perhaps the most important interest of developing countries runs parallel to that of industrial countries: to maintain a high and stable level of economic activity in the world economy. Views have, however, changed over the years as to how much it is reasonable to expect any system to deliver. During the heyday of postwar Keynesianism, it was common to assume that policy could maintain full employment, with the high commodity prices and booming export markets that it brings, at the cost of a stable rate of inflation. Nowadays it is generally believed that any unemployment rate below the "natural rate" [3] will lead not to a stable inflation rate but to an accelerating rate of inflation, since unions will demand and firms will grant wage increases that incorporate expectations of future inflation. Expectations are bound to catch up with reality before long as firms raise their output prices to pass on increased labour cost, which fuels expectations of future inflation.

According to this view, the most that one can ask of an international monetary system is that it avoid major accelerations in inflation and larger recessions than are needed to control inflation, i.e. that it help to stabilise output near the highest level consistent with the continued control of inflation. This implies that the benefits that developing countries can expect to reap from the sort of boom conditions witnessed in the early 1970s will necessarily be temporary; indeed, the benefits of any such temporary boom will be more than offset by the losses suffered during the subsequent recession that will be needed to squeeze inflation out of the system.

A number of economists have followed Keynes' wartime proposals in arguing that countries with a tendency to develop balance of payments deficits – which presumably includes most developing countries – have an interest in a system in which the surplus countries have an obligation to adjust. The original idea is clear enough: in a 2-country world with fixed exchange rates, an obligation on the deficit country to adjust would result in a

3 This is sometimes called the nonaccelerating inflation rate of unemployment, or NAIRU.

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contraction of trade and output, while a transfer of that obligation to the surplus country would replace the contractionary bias by an expansionary one, which would be unambiguously desirable in a world with Keynesian unemployment in both countries. Even if the deficit country had unemployment while the surplus one did not, a transfer of the burden of adjustment to the suplus country would bring a clear benefit to the deficit country. But this clarity vanishes if we accept the argument of the preceding paragraph and recognise that persistent Keynesian unemployment is the exception rather than the rule. The aim of policy becomes to stabilise output near the natural rate, rather than always be seeking to raise it. Moreover, acceptance of the legitimacy of exchange-rate changes as an instrument of the adjustment process reduces the importance of the problem further, since the only "burden" involved in country A devaluing rather than B revaluing is in the former rather than the latter having to announce the change.[4]

However, there is an element of truth in the argument about the desirability of spreading the burden of adjustment. When total world demand is about right and some countries are in payments surplus while others are in deficit, then both groups should be required to contribute to restoring balance, rather than concentrating the obligation entirely on the deficit (or, for that matter, the surplus) countries. Such symmetrical rules will help to dampen the world business cycle.

Perhaps the most famous proposal to use international money arrangements to benefit developing countries was the so-called "link" proposal. This suggested that newly-created international reserves – specifically, SDRs – should be distributed in the first instance to developing countries, who would thus be able to gain a real resource transfer by spending those reserves they obtained in excess of their long-run holding need. (The proposal got its name from the idea that it would link two quite different international objectives, that of providing an increase in the volume of reserves needed to satisfy reserve accumulation objectives and that of securing a transfer of real resources to developing countries in order to accelerate the process of economic development.)

When the link was first proposed, the interest rate on the SDR was very low, and hence receipt of SDR allocations in excess of long-run holding needs would have conferred a clear benefit on the recipient countries. However, in the course of the 1970s the SDR interest rate was raised,

4 In a multicountry world there is a more substantive issue in who changes their exchange rate, since that also influences the cross rates against third currencies. In fact, this should clearly be the dominant criterion in determining whether A revalues or B devalues; but note that this cannot be altered by enunciating a principle regarding the symmetry or asymmetry of the adjustment process.

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essentially to the average market interest rate in the highly creditworthy countries whose currencies were used to value the SDR. This reduced the value of receiving SDR allocations. Indeed, countries as creditworthy as those whose currencies compose the SDR basket no longer received any benefit by receiving SDR allocations. Even less creditworthy countries, such as most developing countries, found the benefit – which consisted of the opportunity of borrowing at the SDR interest rate rather than at the higher rate that they had to pay in the capital market – reduced. Thus the attractiveness of the link declined (though it was not eliminated).

More generally, developing countries clearly have an interest in a system that gives them access to a world capital market from which they can borrow in order to finance a transfer of real resources that will allow them to increase investment. The terms of such borrowing matter, as well as the quantity: clearly long maturities are better than short, low interest rates are better than high, untied loans are better than tied, and debt-service obligations that vary with ability to pay are better than those that are specified exogenously (let alone those that tend to increase when ability to pay declines).

Finally, and presumably most controversially, I at least would argue that developing countries have an important interest in a system with sufficiently well-specified international rules to help them resist self-interested pressures from interest groups and the ruling political elite when these conflict with the interests of society at large. It is by now widely accepted that the international community made a profound mistake when it exempted developing countries from the usual GATT disciplines, since this deprived the governments of developing countries of a powerful argument that they could have used in standing up to the appeals of their protectionist lobbies. Similarly, there is surely a political economy argument in favour of constraining governments, including those of developing countries, from undertaking short-run expansionary policies that compromise a country's long-run prospects, or from building up foreign debt to an extent that threatens to undermine creditworthiness. This argument applies to the United States as much as to any other country.

III. PROPOSALS FOR INTERNATIONAL MONETARY REFORM

A traditional proposal addressed to the first objective discussed above, that of keeping output close to the maximum level consistent with the continued control of inflation, has been to convert the IMF into an embryonic world central bank. This was essentially Triffin's vision of international monetary reform, and it is a vision that inspired European proposals in the Committee of Twenty (C-20) in 1972-74. The basic idea was to add an SDR component

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to the existing and essentially fixed stock of gold, so as to create a world reserve base under the control of the IMF; to write a set of rules (notably asset settlement) that would ensure that monetary expansion in all countries was limited by the size of their stock of reserves; and then to use the IMF's control over the reserve stock in order to achieve a steady rate of growth of international reserves, hopefully thus inducing a rate of growth of nominal income consistent with minimising inflation while avoiding recession.

Although I was a strong supporter of this agenda at the time, I have to say that I no longer regard it as realistic. The reason is that capital mobility has gone too far to make it conceivable that asset settlement might be restored. The tendency since the early 1970s has in fact been all in the opposite direction: instead of the United States being unique in its ability to settle its deficits by issuing its own liabilities, all the other industrial countries have acquired a similar ability to finance deficits by borrowing. Admittedly they have to borrow from the private sector, rather than being able to rely on foreign monetary authorities acquiring their obligations, but the effect is the same: that reserves no longer constitute an effective constraint limiting monetary expansion. If one accepts that the development of capital mobility is irreversible, the idea of controlling the world economy by developing the IMF into a world central bank is no longer within the realm of technical feasibility.

A part of the C-20 agenda was to have regular SDR issues in order to secure a steady rate of growth of the world's monetary base. Would regular SDR issues still make sense once one abandons the attempt to make the stock of SDRs a part of a world monetary base? So far as the industrial countries are concerned, the answer is clearly in the negative; these countries are sufficiently creditworthy to be able to borrow what they need for reserve accumulation on essentially the same terms on which they would receive SDRs.

This is not true for most developing countries. Even those that have access to capital markets generally have to pay an interest premium substantially above the SDR rate, and many cannot borrow on any terms. These countries thus have to export real resources, or borrow on more costly terms than the interest they receive, in order to build up their reserves over time. In effect, the poor countries have to provide reverse aid to the rich in order to build up a prudent level of international liquidity. This is surely unjust; and a case for resuming SDR allocations can be made on the basis of remedying this injustice. Unfortunately, however, this seems to be the strongest case that can be made for allocating SDRs, and it is one that has not so far moved the major industrial countries to action. (Things might have been different if the IMF had got into the habit of making regular allocations, but ironically the dispute over the link was probably a factor in preventing that happening. The arguments against the link were intellectually puerile, but once the depth of the hostility to the proposal in some industrial countries had become evident, a strategic retreat might have been wiser than the rigid insistence dictated by the confrontational North-South politics of the mid-1970s, which effectively killed off the SDR.)

Two other reform proposals from the C-20 era are surely impractical in the age of mobile capital in which we now live. One is to return to the adjustable peg (or "stable but adjustable exchange rates", the famous oxymoron coined by the C-20 to describe the system of occasional large exchange-rate changes). The choices in future are between the classic alternatives of (truly) fixed rates and floating rates, or else one of the intermediate regimes consistent with the continuous maintenance of asset market equilibrium: managed floating, the crawling peg, or target zones where changes in the central rate are limited to the width of the zone.

The other C-20 proposal that should be abandoned once and for all is the idea of controlling or offsetting flows of speculative capital. The upset in the financial world that would be involved by reimposing effective administrative controls on international capital flows makes this a nonstarter. And the size of the official support funds that would be needed to hold a rate in the teeth of expectations that it was likely to be changed by a large amount in the near future (and in the absence of effective administrative controls) would be prohibitive. Reform proposals need to be consistent with the degree of international capital mobility that is now reality.

If one accepts the objectives and constraints that have been suggested above, what scope exists for reform?

A first area is in regard to *policy coordination.* The absence of such coordination has long seemed to me to be the key inadequacy of the international monetary arrangements that followed the failure of the C-20 to negotiate a reformed system, and hence Marcus Miller and I developed a "blueprint" for policy coordination among the main industrial countries in a study published in 1987. This blueprint,[5] which is sketched in an appendix, envisages an agreed set of target zones for exchange rates and agreed formulae for the expansion of nominal domestic demand among the G-7 countries. As stated earlier in this paper, the potential benefits of effective policy coordination are less dramatic than they were customarily painted in an earlier, more Keynesian, era; but I would still argue that developing countries would stand to benefit from the arrangements that curbed outbursts

5 John Williamson and Marcus Miller, "Targets and Indicators: A Blueprint for the International Coordination of Economic Policy", Institute for International Economics, Washington, 1987.

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of global inflation and limited global recessions, as the blueprint proposals are designed to do.

A second, related area of possible reform stems from the remarks in the previous section about the desirability of developing (and industrial!) countries subscribing to *a set of international rules that would limit their freedom to act against their own long-run interests.* The blueprint proposals for policy coordination are aimed inter alia at providing such constraints for the largest industrial countries, as well as ensuring the mutual consistency of their policies (an objective that matters only for the largest countries, which is why it makes sense to present these as two distinct reform proposals). One would want such a set of rules to create a strong presumption against the things that tend to be popular in the short-run at the cost of mortgaging a country's future: excessive levels of indebtedness (both domestic and external), excessive deficits (both fiscal and balance of payments), an uncompetitive exchange rate, and an excessive pressure of demand.

None of these things is easily and unambiguously measurable, which means that any agency responsible for monitoring country performance and publicising its findings would have to rely on projections, estimates, and rules of thumb (such as the Maastricht limits of 60% and 3% for debt/GNP and deficit/GNP respectively). This would presumably result in any international agency which took on this role becoming exposed to domestic political controversy, but this seems inevitable; if there were no risk of its decisions being controversial, there would be no need for an agency to make these judgments in the first place. This political sensitivity of the role raises some question as to whether the obvious international agency for this role, namely the IMF, would be suitable. One may hope that the more sympathetic image the Fund has acquired among developing countries in recent years would suffice to overcome its baggage from the more distant past, since one would surely not want to duplicate the sort of expertise concentrated in the IMF.

Another clear interest of developing countries is safeguarding their access to capital markets. These are at present open to countries that the markets judge to be creditworthy, and they will surely remain so; the problem is to make countries more creditworthy. Here it seems to me that a major international initiative is called for, and that the time is now ripe.

The initiative that I have in mind is the creation of a *legal mechanism for the revision of international debt contracts.* The absence of any such mechanism (often described as a parallel to the Chapter XI proceedings under the US bankruptcy law) was often deplored during the debt crisis, since it meant that there was no third party available to adjudicate between debtors and creditors when the former found the continued observance of the contracts that they had signed to be unacceptably onerous. The deterioration in the global environment that took place in the early 1980s was clearly not foreseen when the debts were incurred,

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but the debt contracts contained no provisions regarding the revision of their terms if unfavourable contingencies materialised. In the absence of any legal mechanism, debtors had little alternative but to modify their contracts unilaterally, since creditors can hardly be expected to volunteer to receive less than that to which they are contractually entitled. The resulting conflicts were costly to both creditors and debtors.

Several authors have suggested the desirability of establishing a quasi-legal institution charged with renegotiating debt contracts, i.e. an International Debt Restructuring Agency.[6] This might be linked to the Bretton Woods institutions or it might be independent of them. It might act essentially as a mediation or conciliation agency, having its legal powers confined to those needed to impose on the dissenting creditors revised terms agreed by the debtor and a qualified majority of its creditors. Alternatively, such an Agency might take the form of a tribunal with the power to award debt relief through arbitration even against the wishes of the majority of the creditors.

Such a tribunal would need to have its awards based on agreed criteria as to the circumstances in which a country should be entitled to debt relief. Suitable criteria might include:

- exogenous shocks that had led to a substantial unexpected increase in the burden of debt service
- low and declining per capita income
- the lack of a threat to international financial stability
- a presumption that economic recovery is being impeded by a debt overhang
- poor use made of the proceeds of the loan (reflecting inadequate monitoring by the lenders)
- failure of the lender to make a serious assessment of the probability that the borrower may encounter difficulty in servicing its debts
- doubtful legitimacy of the government that contracted the loan
- refusal of the lenders to extend further loans in support of an internationally agreed adjustment programme.

These criteria are intended to provide an incentive for the lenders to behave responsibly, as well as to identify circumstances in which efficiency considerations would indicate a need for debt relief. The fact that relief would depend upon an international mechanism rather than emerging from

6 The term comes from Benjamin J. Cohen, "Developing-Country Debt: A Middle Way", Princeton Essays in International Finance no. 173, 1989. Similar ideas were presented earlier in Jeffrey Sachs, "Managing the LDC Debt Crisis", Brookings Papers on Economic Activity, 1986(2), and John Williamson, "On the Question of Debt Relief", appendix to the "Statement of the Roundtable on Money and Finance", Society for International Development, New York, 1985.

threats and bargaining could be expected to increase the speed and decrease the costs of achieving debt restructuring.

An International Debt Restructuring Agency would base its legitimacy on clauses in future loan contracts specifying that the terms of the contract could be revised by the agency to take account of unforeseen contingencies, and that both creditors and debtors would be bound by its decisions. Any debtor that unilaterally revoked this clause would have to anticipate facing sanctions, a consideration that should reassure creditors that it is safe to engage in lending as long as they take care to stay within the bounds of prudence. (The second criterion reflects a judgment that it is imprudent for commercial lenders to finance low-income countries, which ought to look to official sources for concessional finance.)

It is difficult to imagine that the commercial banks might have agreed to the creation of such an agency, with the right to adjust the terms of existing contracts, while the debt crisis was still in progress. The current lull would seem an opportune moment to raise this issue. Its creation at this time might also help to address the current problem of deterring excessive capital inflows to Latin America, since those making loans under current circumstances might well be judged guilty of imprudence if debt problems emerge subsequently.

The suggestions advanced above do nothing to allow developing countries to acquire the trend increase in their reserve needs without making a reverse transfer of real resources to the developed countries. The obvious instrument to that end remains *a resumption of SDR allocations.* Is it possible to conceive of a formula that might conceivably entice the industrial countries to abandon their opposition to SDR allocations?

Consider the following idea. The IMF would survey how many countries were unable to borrow internationally at an interest rate close to (say within 1 per cent of) the SDR interest rate. If a substantial block of countries (say those with IMF quotas totalling one quarter or one third of the total) were found to be in that situation, the Fund would aim to issue as many SDRs as those countries had revealed they wished to hold. Countries' revealed desires would be measured by the actual past increase in their reserve holdings during the preceding five-years ("basic") period. The IMF would then calculate the scale of SDR allocation that would be needed to supply those countries in aggregate with a similar reserve increase during the forthcoming basic period, and would issue SDRs on that scale.

All participants would receive SDR allocations over the following five years on the scale needed to satisfy the revealed reserve needs of the less creditworthy countries. Since reserve needs tend to grow more rapidly in absolute terms over time, this would in general mean that the less creditworthy countries would not in fact be able to satisfy their entire reserve accumulation objectives through SDR allocations, but they should be able to satisfy the bulk of them that way. Receiving SDR allocations is a matter of complete indifference to a creditworthy country; however, these countries would suffer collectively to the extent that the less creditworthy countries would no longer have to export real resources [7] to them in order to build up their reserves. The hope would be that allocation on the scale determined by this formula would enable the creditworthy countries to recognise that this loss would simply end existing payments of reverse aid (by the poor to the rich) rather than constitute additional aid.

IV. CONCLUDING REMARKS

I have argued in this paper that many of the traditional proposals for international monetary reform have been overtaken by events, notably the growth of a global capital market. Given the basic judgment that this development is not reversible (whether or not one would welcome it being reversed), it follows that there is no point in pursuing proposals for a world central bank, [8] reinstatement of the adjustable peg, or the control of speculative flows.

But the disappearance of this traditional agenda does not mean that there are no worthwhile reforms to pursue. I have sketched the case for the following four reforms:

1. Adoption of the Williamson-Miller "blueprint" for policy coordination.
2. Agreement that an international agency (the IMF?) be charged with the responsibility for monitoring country policies and issuing public warnings about unsustainable policy choices.
3. Introduction of an International Debt Restructuring Agency charged with revising the terms of international debt contracts when exogenous circumstances change in a way that makes it excessively costly for a debtor to fulfill the terms of its initial contract.
4. Resumption of SDR allocations, based on a formula designed to enable the less creditworthy countries to satisfy their long-run reserve accumulation objectives without the reverse aid implicit in current arrangements.

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7 Or, for those with some creditworthiness, borrow; but (unlike the countries being described as creditworthy) paying a premium over the SDR interest rate.

8 Of course, that will change if and when the world reaches the point where it is ready to consider the possibility of moving to a single currency. What has vanished is the idea of a two-tier structure in which national central banks are influenced by the attempt to maintain a more or less constant reserve ratio at a world central bank.

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Appendix

The Williamson-Miller Blueprint for Policy Coordination

The blueprint assumes a conventional specification of the goals of macroeconomic policy. Governments like a high level of activity (implying also a high rate of growth and a high level of employment). They dislike inflation, with an intensity that grows progressively as inflation rises. And they have some objective, at least within a range, for their balance of payments on current account. This is not necessarily a zero balance, but at a minimum it must be a range within which any imbalance will not raise questions about the sustainability of financing. Of course, some governments may have well-defined ideas about the desirable level of lending to, or borrowing from, the rest of the world.

Governments cannot in general have everything they would like. Trade-offs must be faced. In particular, lowering inflation generally requires some temporary slack in the economy. Higher activity tends both to increase inflation and to worsen the current account. A more competitive exchange rate, designed to improve the current account at a given level of activity, tends to increase inflationary pressure.

The blueprint is based on using a medium-term framework to resolve these trade-offs. Each of the participating countries – say the members of the Group of Seven (G-7) – would be expected to have some notion of the natural rate of unemployment (NAIRU). Their choice should be continuously monitored for realism by whatever international secretariat (presumably the IMF) that was charged with responsibility for servicing the policy coordination process. Each country would also select a current account target. Where a government had no precise view on what current account balance was appropriate, one could take the middle of the range that was judged to be sustainable as the provisional target.

The secretariat would then have to appraise the mutual consistency of the various targets, taking account of what appears sustainable and acceptable to the rest of the world. If an inconsistency emerged, it would have to be bargained away; the less governments have precise views on current account targets, the less troublesome this should be. Finally, one would need to check that the chosen NAIRUs were consistent with the current balance targets. (To the extent that a more favourable current balance implies a more competitive exchange rate and thus lower real wages, it would tend to raise the NAIRU if wage-earners have a target real wage.)

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Each country would commit itself to a macroeconomic strategy designed to lead to simultaneous "internal balance" – defined as unemployment at the natural rate and minimal inflation – and "external balance" – defined as achieving the target current account balance – in the medium term. Since exchange rates affect trade only with long lags, this implies a commitment to hold the exchange rate close to the level [9] needed to reconcile internal and external balance during the intervening adjustment period. This is the exchange rate that I call the 'fundamental equilibrium exchange rate' (FEER), in recognition that it is the exchange rate that implies an absence of 'fundamental disequilibrium' in the old Bretton Woods sense [10]. Policy should be directed to keeping exchange rates reasonably close to their FEERs. (Because of doubts as to whether the authorities of the major countries would be wise to give overwhelming priority to exchange rate targeting, the proposal allows for wide bands and, in extremis, soft margins.)

The other intermediate target, in addition to the exchange rate, is growth of nominal domestic demand. The idea of targeting this is a slight variation on the proposal to seek a constant growth rate of nominal income. It has most of the advantages of a nominal income target, in terms both of providing a constraint on inflation (a 'nominal anchor') while allowing some elasticity to mitigate a supply shock, and of avoiding the shocks that come from a money supply rule when velocity changes.

Our proposal to endogenise the rule would allow rather more accommodation of an inflationary shock and rather more effort to combat a recession, for two reasons. One is the view that a limited softening of policy is capable of reducing the short-run costs of adverse shocks. The other is that if governments are asked to subscribe to excessively 'harsh' rules they are likely to abandon them just at the time when continued confidence demands that their resolve to stick to rules that will re-establish price stability in the medium run needs to be reinforced.

Our other innovation is to require governments to target the growth of domestic demand rather than income: the difference between the two is the change in the current account balance. Our rule calls on a country with an undesirable large current account deficit (surplus) to target a slower (faster) growth of domestic demand than its desired growth of nominal income, so as to promote correction of the trade imbalance.

The final step involves translating the implications of the two intermediate targets into 'rules' to guide monetary and fiscal policy. We suggested three such rules, subject to two constraints.

9 Or, strictly speaking, the trajectory.

10 John Williamson, "The Exchange Rate System", Institute for International Economics, Washington, revised edition 1985.

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Rule 1 says that interest rate differentials among countries should be adjusted when necessary in order to reinforce intervention in the exchange markets so as to limit the deviations of exchange rates from their FEERs to target zones. This rule recognises the elementary fact of life that the only effective instrument for managing exchange rates is monetary policy. It does not imply that monetary policy must be devoted exclusively to exchange rate management, because a wide target zone allows substantial scope for monetary policy to be directed to domestic objectives, but it does require that in extreme situations the authorities give priority to the exchange rate.

Rule 2 says that the average world interest rate should be adjusted upwards when the aggregate growth of nominal domestic demand is threatening to exceed its target value (the weighted average of the national targets), or downwards when demand growth is too low. Rule 1 only deals with interest differentials and fails to pin down the average interest rate in the system. It raises the question as to which country should adjust if two currencies reach the limits of the target zone: the one with the weak or the one with the strong currency. The answer offered by Rule 2 is that if aggregate 'world' (in practice G-7) demand is growing too rapidly the weak-currency country should raise its interest rate, while in the converse case of inadequate growth it should be the strong-currency country that should cut its rate. This provides a world rule for aggregate monetary policy to replace the 'dollar standard rule' that the nth country should seek domestic stability while the other n minus 1 countries follow Rule 1. It is the key to constructing a symmetrical monetary system of the form that will be appropriate for the multipolar world of the twenty-first century.

Rule 3 says that if the monetary policy called for by Rules 1 and 2 threatens to prevent nominal domestic demand growing at close to the target rate, fiscal policy should be adjusted to compensate. This rule calls for the 'Keynesian' use of fiscal policy to ensure that an exchange-rate-oriented monetary policy does not destabilise domestic demand. Such overt use of fiscal policy became unfashionable in the 1980s, but for no good reason: on the contrary, experiences such as the post-1982 expansion in the United States and the post-1987 expansion in Japan demonstrated that fiscal policy had lost none of its power when the conditions assumed by Keynes (excess capacity and financial confidence) were present.

Constraint 1 says that if fiscal policy is threatening to lead to an unsustainable debt build up, Rule 3 should be overridden if it calls for an expansionary fiscal policy.

According to Constraint 2, if world real interest rates remain abnormally high (say, more than 4 per cent per year) for a sustained period, there should be a concerted global fiscal contraction.

On reflection, I am not sure that the combination of a short-run

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anticyclical 'rule' and two constraints motivated by medium-term concerns is necessarily the best way to have specified the conduct of fiscal policy. Perhaps one might instead have started off by asking each country to identify the medium-run fiscal stance compatible with its current-account target, a sustainable debt position, and a 'normal' real interest rate (say 3 per cent). It would then identify a medium-run (say five-year) path for adjusting its fiscal deficit towards the target position. Rule 3 would then be naturally interpreted in terms of deviations from this target path. This reformulation would make it clear that there is a close medium-term link between fiscal policy and the current account deficit.

The blueprint has three objectives. One is to constrain the foreign exchange markets, so as to discourage speculative fads. A second is to constrain governments into acting according to preannounced criteria suggested by the reasonable robust bits of macroeconomic theory and embodying a strong commitment to restoring equilibrium in the medium run, or else justify publicly any deviations that they may feel it expedient to make. The third is to ensure that the policy objectives of the major governments are mutually consistent.

Comment on "International Monetary Reform and the Prospects for Economic Development," by John Williamson

Horst Bockelmann

I read John Williamson's paper with a great deal of interest. There is a lot in his discussion of past experience which I find interesting and which I have not seen elsewhere in quite the same terms. I tend to agree with him that the world had outgrown the adjustable peg system in the early 1970s, although I am surprised not to find among his reasons for this the question of the gold price and only in a very indirect way the fact that from the mid-1960s onwards the United States had failed to provide a stable anchor for the Bretton Woods system. On another point he suggests that parity changes in the EMS had been kept small enough to avoid speculation, which was, however, not foreseen at the beginning. This particular approach actually only represents an intermediate stage after a substantial convergence of inflation rates but before it was discovered that with credibility and, if necessary, with bold short-term interest rate adjustments realignments could be avoided altogether.

But this is not what Williamson whishes us to focus on. He has put forward a revamped agenda for reform of the international monetary system, and presents four reforms which to me seem oddly unconnected. One gains the impression that, in this way, he could also make three or five proposals. It does not strike me as a coherent programme for reform. Perhaps for this reason I feel free to take up his four proposals in reverse order, dealing first with those where I can be rather brief.

Let me start with his suggestion of a resumption of SDR allocations aiming at the less creditworthy countries. I agree with him that there is injustice in poor countries having to provide reverse aid to rich countries in order to build up a prudent level of international reserves. But, I am afraid, there is a lot of injustice in the world and feeling obliged to suggest a special solution in such cases seems to me a bit strange. The burden of having to hold an essential amount of money, whether national or international, always weighs more heavily on the shoulders of the poor than of the rich. By all means let us help them to be less poor, but let us not try to deal with one particular symptom of poverty! By the way, when Williamson says that the arguments against the link have been intellectually puerile, he seems to imply that

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concerns about moral hazard have no intellectual standing. The link would indeed have been a classic case of moral hazard.

Coming to another proposal in Williamson's paper, I fail to see what purpose it could serve to re-create the IMF under a different name. If, as he seems to suggest, the new institution would be expected to be even tougher with national policymakers than the IMF ever had the courage to be, the new institution would quickly be cast in the role of scapegoat just as much as, or more than, the IMF has been. I see a glimmer of hope in this respect, though, as many developing countries now have a better idea of what policies hold out a prospect of success than they had in the past.

Williamson's second proposal concerns the establishment of a legal mechanism for the renegotiation of international debt contracts in the form of an International Debt Restructuring Agency. Would that help developing countries which have problems with creditworthiness or would it harm them? It is of course the recent experience of the debt crisis that puts the idea of special treatment of the foreign debt of developing countries in people's minds. Yet the two lessons to be drawn from this crisis are rather general, and do not suggest the need for new institutional arrangements:

1. Many developing countries did not put borrowed money to good use and pursued irresponsible domestic policies. Creditworthiness depends on the pursuit of the right macroeconomic policies at home – not on new international initiatives;
2. Banks were overeager to lend, but too undemanding in the conditions they imposed. There were many reasons for this, and the banks had paid a high price that has made them more cautious. This is no bad thing: it does not help anybody to grant them loans they cannot service.

Creating a special agency with the power to renegotiate debts seems a typical case of preparing for the last war. It might have been useful had it existed in the mid-1980s. For the future as seen from today it can only create uncertainty in the minds of potential foreign lenders – especially private banks – and make them more reluctant to lend. In other words: developing countries would be hurt, not helped. The criteria that Williamson proposes for possible debt relief would be good reasons for not granting a loan in the first place, so one wonders whether what he has in mind is in fact an International Debt Contracting Agency, empowered to permit – or instruct – banks to lend developing countries.

Presumably not: one could not subject the global capital market to such constraints. During the last couple of years, indeed, capital has been flowing back to the developing world on a substantial scale. Official reserves in the developing world grew by only a little less that $90 billion in 1990 and 1991 taken together (not including the Asian NICs). There is therefore no generalised shortage of reserves in the developing world. A number of

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countries – notably in Latin America – have seen their access to international capital markets improve markedly over the last year or so.

Let me add here a general thought on national creditworthiness. I think it is important that this concept should attract more attention than it has in the past. Most developed countries operate with such a wide safety margin in this regard that they are never forced to consider what it is that national creditworthiness depends on. The term "sovereign risk" in this context conjures up the idea of the state controlling all foreign borrowing decisions. In practice, in many countries that got into trouble such decisions were decentralised. Now the point which is often overlooked is that individual decision-makers cannot take proper account of possible future difficulties in obtaining the foreign currency needed to service their foreign debt. There is actually no effective price mechanism to transmit the external contraints which exist at the macro-level for national economies to the decision-makers at the micro-level. They cannot foresee or prepare for a sudden loss of the country's creditworthiness. Their own project may be highly successful, but such a loss of creditworthiness may still prevent them from servicing their debt.

Avoiding this problem requires the wide safety margin I referred to. This gives macroeconomic policy the time needed to react to any adverse movement threatening national creditworthiness and to cope with large fluctuations in international capital flows. With convertible currencies and exchange rate adjustments, highly developed financial markets provide a large cushion. In small developing countries all this is lacking. Frankly, I simply do not believe they can afford decentralised decision-making on foreign borrowing and foreign investment unless they have gone a long way towards establishing a firm reputation for national creditworthiness. The most difficult cases in this regard are probably those larger developing countries which either have a tradition of free markets or quickly want to get rid of dirigiste bureaucracies but have not had the time to build and earn international creditworthiness with the safety margin that is required to sustain it beyond doubt.

Let me now turn to John Williamson's blueprint for policy coordination. It is in fact not evident what the adoption of his blueprint would do for developing countries, i.e. in the form of a more stable trade environment. Does he expect it to push up the level of demand in the world economy in general? As to the avoidance of misalignments between the major industrial countries, it is pretty clear that these countries are not prepared to commit themselves along the lines Williamson suggests. They can point out that they have managed to keep exchange rates reasonably stable since February 1987 even without such a straitjacket.

But this is not to say that his basic idea is not right. I have been trying to

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make the same point for a number of years. Just as under the system of fixed exchange rates a country's economic policy in the broadest sense is called upon to maintain the convertibility of its currency, under floating economic policy is called upon to maintain a reasonable degree of real exchange rate stability. As exchange rates are a multilateral matter, a reasonable degree of stability of real exchange rates at acceptable levels can only be achieved by coordinated policy action by the countries in question. For the system of floating exchange rates to work satisfactorily, coordination of the policies of key currency countries is to me an essential component. Time does not permit me to consider the question of how best to translate real exchange rate objectives into nominal exchange rate strategies and what role intervention might have to play. Of greater significance is perhaps to what extent the discussion of dirty floating had swayed attention in the wrong direction. There are also nagging doubts as to whether even all these efforts put together can be expected to succeed under all circumstances, given the size of short-term capital flows in globalised financial markets.

Indeed it is this growth of the global capital market that has made many grand schemes for international monetary reform look irrelevant. International capital markets are now deep, flexible and highly inventive (even if they make blunders) and would be capable of financing development worldwide if only domestic reform and policy improvements in the LDCs themselves would provide the preconditions for the latent profitability of investment in LDCs to be realised. While I am not suggesting that there is no need for development aid, it remains true that the more the developing countries can do by themselves for themselves, the better. In this context, Williamson makes an important observation with which I heartily agree: exempting LDCs from the usual GATT discipline did them great harm by depriving their governments of a powerful argument against protectionist lobbies.

Let me briefly sum up. While I am sceptical about his specific proposals, I must say that John Williamson has given us some interesting food for thought, and I share many of his points of view. I believe the issue of national creditworthiness which he addresses is an important one for developing countries, and one that needs to be pursued further.

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Comment on "International Monetary Reform and the Prospects for Economic Development," by John Williamson

Ariel Buira

In discussing what scope exists for the reform of the international monetary system John Williamson begins by pointing out that official arrangements depend on the evolution of markets and on the position of the private sector. That leads him into a discussion of some proposals for reform that have been overtaken by events. I am tempted to add that it is not only world financial markets that have changed since the 1970s, but also that the world political balance has altered against the developing countries, in favour of the Western industrial countries, and that the 1980s have been characterised by a decline in the climate for international cooperation. This is the new world order. This may affect the prospects for reform.

The industrial world itself has now become tri-polar, as the relative weights of Asia and Europe in production, money and trade matters have approached that of North America. The increasing diversification of currencies in trade and international reserves implies greater risks of exchange rate volatility and misalignments and also greater need for shared decisions and responsibilities in international monetary matters. But increased monetary cooperation is unlikely to come about if it is not as a result of a crisis, or at least of increased tensions that are perceived as dangerous by the major industrial powers, for reasons that will become apparent.

Let me turn now to the four proposals put forward by John Williamson.

Policy coordination and improved national policies

There can be no question that the present system has not sufficiently promoted adequate national policies and policy coordination amongst industrial countries. Undisciplined fiscal policies and low levels of national savings characterised most of the G-7 countries over the 1980s and still do. It has long been recognised that unsound and inconsistent policies have been major elements in the volatility and misalignments of the exchange rates of major currencies. In a convertible currency system, exchange rate stability depends essentially on current and prospective macroeconomic policies and performance.

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As for fiscal policy, two major shortcomings come to mind. First, the persistence of large deficits, which have the effect of absorbing a significant portion of world savings and contribute to raise international interest rates, discouraging investment and aggravating the problems of debtor developing countries and more generally of capital importing countries.

The second problem relates to the virtual abandonment by many countries of fiscal policies as a tool of stabilisation, consequently placing excessive reliance on monetary policy to achieve both internal and external balance.

It would seem that the democratic process often raises insuperable obstacles to the adjustment of taxes and expenditures for stabilisation purposes. Moreover, countries with large fiscal deficits find that the counter-cyclical role of fiscal policy is severely limited. Of course, we are all aware of the practical difficulties of making fiscal policy changes in a timely manner and of pitfalls of fine-tuning. But perhaps greater reliance on automatic stabilisers as a means of stimulating or reducing aggregate demand at appropriate stages of the business cycle would be appropriate.

A third point on the adjustment process, one which is a major shortcoming of the present arrangements, is that there is no provision to encourage adjustment by surplus countries. Consequently, the burden of adjustment is not shared symmetrically between surplus and deficit countries, – which would reduce the efforts required of the latter – but falls entirely on deficit countries.

Experience suggests that the success of any scheme to improve the workings of the present system depends on the cooperation of the major industrial countries. Particularly on their willingness to submit themselves to a considerable degree of mutual policy adjustment and discipline to achieve a better economic environment for all. But the issue is not simply to have clearer rules of the game for exchange rate and macroeconomic policies, but to gain the compliance of all parties. Can the major currencies be persuaded? If clearer rules on policy coordination had been in place, would the US or Italy have reduced their fiscal deficit or increased domestic saving, so as to make a greater amount of resources available to the rest of the economy and to the world? Would Japan have run much smaller current account surpluses? It seems to me that this is not the case. As a rule, the policymakers of major powers tend not to accept limits on their freedom, except when this is the solution to a conflict whose costs can be higher. It will probably have to get worse before it gets better. Moreover, to be effective, rules have to have teeth, like the gold standard did, or a form of asset settlement. I don't believe as a practical matter that you will secure the discipline of the strong merely on the basis of goodwill (e.g. Earth Summit at Ro).

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International liquidity and SDR allocations

I think there is broad agreement that the adequacy of international liquidity does not turn only on the total amount of reserves but on their distribution among countries, and on their access to credit from international financial markets and official sources. While there may be discussion as to whether the growth of liquidity has kept pace with the expansion in world trade and other needs – here the increased needs of the former Soviet Republics would have to be considered – there is no question that with regards to the distribution issue, the current system is unsatisfactory.

Today most countries in the world, accounting for most of the world's population are not considered creditworthy, except to a very limited extent, and thus face a shortage of international liquidity.

The G-10 might argue, as they did in their 1985 report, that while most countries have no access to financial markets, this is due to their poor policies, and that creditworthiness and higher reserves are the reward of good policies. Surely this smug view is too simplistic. Is the US access to international financing due to their sound fiscal and exchange rate policies over the last ten years? Are the changes in terms of trade, in international interest rates and protectionism that affect the developing countries irrelevant to their creditworthiness? The fact is that while policies matter, "fairness" in access to markets is not assured and as illustrated by Colombia, access is often subject to important exogenous factors, including the "bandwagon" and "contagion" effects.

The fact is that the system of development financing that had evolved in the 1970s and collapsed with the debt crisis in the 1980s, has yet to be replaced by something else.

Thus, Mr. Williamson's proposal for the resumption of SDR allocations has a strong base. However, I am not sure that the formula he proposes for distribution, i.e. to base allocations on past increases in reserve holdings during the preceding period, is appropriate. For one, it continues the reverse transfer of real resources to industrial countries in order to accumulate reserves in the five years. It strengthens the deflationary bias existing in an international monetary system where liquidity is scarce for most and where surplus countries are not required to contribute to the adjustment process. Secondly, it does not take into account the impact on reserves of exogenous phenomena like changes in international interest rates, changes in terms of trade, natural disasters or of the impact of protectionist restrictions on the exports of LDCs. Thus, if the purpose of the formula is to move away from the present system of "to him that hath shall be given", this is not it.

Ideally, SDR allocations would seek to meet in part the international liquidity needs of countries. Perhaps they could share widely amongst the

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developing countries, the benefits of international seigniorage accruing to key currency countries. Instead of having real transfers from poor to rich countries as today, the system should as a minimum be neutral as regards its redistribution effects. As it is today, the SDR is left as a safety net to be activated only in case it suits the major countries.

International Debt Restructuring Agency

The IMF and the international community have for some years expressed support for the concept of "adjustment with growth". However, adjustment with growth requires, in addition to strong and sustained adjustment efforts of debtor countries a favourable international economic environment and the provision of adequate financial flows to facilitate and support adjustment programmes. In fact, the recent performance of the international economy has been mediocre. As to financial flows, debtor countries have faced the task of adjustment with substantial net negative transfers of resources. This may be contrary to Fund doctrine but is in conformity with experience and goes a long way to explain why so many adjustment programmes fail. This raises several issues relating to the size of the Fund, i.e. its resources, which even after the 9th Quota Increase comes into effect will be inadequate to meet the needs of the developing countries and former Soviet Republics; and the related point of policies on access to Fund resources, i.e. limiting access or ensuring financing flows that are consistent with the minimum requirements of adjustment with growth.

I have long favoured an agency with the authority to revise the terms of existing debt service obligations for countries whose exogenous circumstances have materially changed. Indeed, I suggested the Fund should take on such a role in 1986 and 1988. Most countries have Chapter 11, or similar procedures to save companies in difficulties from failing. Don't countries deserve as much?

However, to be viable the proposed agency would have to be endorsed by the governments of major creditor countries. Indeed, these countries would have to enact legislation or enter into an international agreement which overruled domestic law of contracts. Would they do this? I don't think so. I believe the time for this has passed. The debt crisis no longer poses a systemic problem. Creditors are satisfied with the current "case by case" approach. It allows them to recognise important differences in the policies followed by debtor countries and to assist only those that they feel merit support. To have any chance an International Debt Agency would have to condition relief to the pursuit of appropiate policies, à la Brady Plan, and be run by creditor governments in fact, if not in name. (Japan would certainly oppose any such procedure particularly if it covered debt to official creditors.) Major creditor

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governments prefer the present situation by which they can, at their discretion, offer relief to a friendly debtor country but not to another. The selectivity in the cases of debt relief for Egypt and Poland, but not for Peru which is in a more desperate situation bears this out.

Should it be established, the rights of debtor countries to resort to this agency would have to be irrenounceable. Otherwise, all future contracts would simply have an additional clause by which borrowing countries would undertake not to resort to the said agency under any circumstances.

Moreover, I suspect that most international banks would also be opposed to any scheme for the revision of debtor contracts, since in some sense this would reduce their rights and their freedom to take discretionary action, possibly in exchange for certain favours.

An international agency charged with the responsibility for monitoring country policies and issuing public warnings about unsustainable policies

No one can object to good policies or favour bad ones. Thus an international agency that would warn countries not to act against their own long-run interest, although somewhat paternalistic, may be a good idea. But why the "may be"? Several issues immediately come to mind.

The first one is the question of a possible double standard. An agency with responsibility for monitoring country policies would tend to have more leverage and put more pressure on small LDC debtor countries than on industrial countries that do not require its assistance and whose bureaucracy is often better able to answer back. An asymmetry of treatment between these two groups of countries, is particularly questionable, since the policies of the larger industrial countries have a greater impact on the world economy.

A second misgiving relates to the issue of public warnings. Note that a public warning, say by the IMF or some such agency, on the unsustainability of an exchange rate is most likely to provoke an exchange crisis. Do we want this?

On the other hand, public warnings on the need for future correction of grossly mistaken policies, such as excessive public deficits or levels of borrowing could be useful, although they would have important immediate consequences, both for domestic interest rates and exchange markets and on the availability of external credit. In any event, one cannot entirely dismiss the possibility of the international agency charged with the task, being wrong in its judgement. Since economic policy is not an exact science, this can happen.

Let me take for instance the question of exchange rate management. From the 1950s up to a few years ago, the IMF and numerous economists dealing

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with international adjustment tended to rely heavily on changes in exchange rates to correct current account imbalances. Since then, we have re-learned a great deal. Devaluations to be successful require the existence of "money illusion" to achieve a cut in real wages and a decline in consumption. However, in countries which have experienced high rates of inflation and successive devaluations, the money illusion is quickly lost, and exchange rate changes are usually accompanied by rapid wage and price increases that entirely offset the depreciation. The result then, is simply a new round of inflation.

This has led the authorities of many countries to think that, rather than try to compensate for inflation differentials through changes in the exchange rate, it may be best to seek a sustainable balance of payments position through demand management, particularly through diverse measures of deregulation and structural change aimed at improving the efficiency and competitiveness of the economy.

Moreover, the agency could easily fall prey to what could be called an involuntary "creditor bias". This can be described as a wish to see no loss of competitiveness in a debtor country, meaning that the real exchange rate should be held constant, however undervalued the curency was in a given base year. But, in an open economy it is impossible to maintain a substantially undervalued exchange rate, simply because the prices of traded goods in local currency will tend to adjust to the equivalent of their international price. Thus it is not surprising that the real rate should appreciate.

Moreover, it is impossible to maintain a constant real exchange rate and to stabilise an economy at the same time. Any inflation would require an offsetting depreciation, which in turn would feed inflation, giving rise to a vicious circle by which inflation is perpetuated.

On balance, if questions may arise as to the quality of the advice given and on the desirability of giving publicity to policy recommendations, countries like adults, might prefer to listen to the advice given privately and then, to consider it and to make their own decisions. That is what I would prefer. To conclude, I would agree much more with the diagnosis than with the prescriptions proposed by John Williamson.

Areas of consensus

Since I have been asked for some points of possible consensus, some broad areas come to mind:

1. One would be the lack of discipline and coordination of major countries which aggravates the asymmetry of the adjustment process, which aggravates the savings shortage, which results in misaligments of exchange rates and their variability, and which favours protectionism.

2. A second area is the clear shortage of international liquidity for most of the world. Some form of liquidity creation – which does not imply a reverse transfer of resources – is desirable.
3. A third area might be the inadequacy or insufficiency of resources to support the adjustment process. This has certainly to do with the size of the International Monetary Fund, but it is also related to the design of the adjustment programmes. I think, a revision of conditionality and Fund policies is needed to favour adjustment with growth, which today is really more of a declaration than a fact.
4. A fourth area would be to address the problem of the shortage of development financing, since the arrangements that existed in the 1970s have broken down. This means probably dealing with greater resources for the World Bank and other development institutions.
5. A fifth area would be the persistence of the debt crisis. After ten years it is no longer a problem that poses a systemic risk to the world financial system, but it is still blocking the development of many middle- and low-income countries.

Comment on "International Monetary Reform and the Prospects for Economic Development," by John Williamson

Mitsuhiro Fukao

After briefly reviewing the weakness of the present international monetary system, John Williamson proposes the following four reforms: (i) improve the policy coordination process by adopting a fairly detailed code of conduct on monetary and fiscal policy (the so-called "Blueprint" of Williamson and Miller); (ii) create a legal mechanism (e.g. an International Debt Restructuring Agency) for the revision of international debt contract to smooth debt restructuring processes; (iii) adoption of a set of international rules that would limit the freedom of policy that act against their own long-run interest (for example, excessive external borrowings, uncompetitive exchange rates and large budget deficits); and, (iv) a resumption of SDR allocations to compensate perverse real transfers from LDCs to developed countries, generated by increasing reserve holdings of the LDCs.

While I agree with him about the existence of weakness in these areas, I do not think the proposed reforms will rectify these problems.

Enhancing policy coordination and surveillance process

Regarding proposals (i) and (iii), I would like to point out that policy coordination has been tried by the G-7 process and the rule was broadly consistent with Williamson's proposal. In Japan, it was generally felt that the process put too much burden on Japanese monetary policy. The excessive easy monetary policy in the late 1980s to counter the appreciation of the yen has induced an asset-price inflation and the Japanese economy is now trying to cope with its overhang. Moreover, the process has been rather unilateral; the United States did not (or could not) control its fiscal policy and tried to pressure the other G-7 countries to adjust their policies. If the United States would not control its fiscal policy, there is little use in policy coordination.

The IMF has conducted surveillance with its credit as a stick. However, it has not been effective for developed countries that can borrow freely in international financial markets. The OECD has conducted surveillance with a published OECD survey as a stick, but it has not attracted enough press attention in larger countries to be truly effective. One possibility would be to apply the Maastricht criterion on fiscal policy (3 per cent deficit/GDP and 60

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per cent debt/GDP ratio) to non-EC developed countries as a basis of surveillance. The treaty has teeth; the EC can levy fine on offending governments after a warning. However, this level of enforcement of the rule is clearly too ambitious for the G-7 countries.

Thus, it is necessary to find a stronger sanction than the ones already in place but one that is still acceptable to countries participating in the surveillance exercise. One possible sanction against those countries with disruptive policies would be to allow the IMF to declare that they are conducting unsustainable policies. By linking BIS capital weight on national debts to this status, the world community can put stronger pressure on both developing and developed countries. (Under the current BIS rule, national debts of OECD countries and Saudi Arabia carry zero risk weight, while debts of all other countries – unless denominated in respective national currency – carry 100 per cent weight.) I will elaborate on this proposal at the end of my comment.

International Debt Restructuring Agency

With regard to Williamson's second proposal (an introduction of international Chapter XI of US bankruptcy code to LDC debt restructuring), it is necessary to distinguish the difference between companies and countries. A company is controlled by its shareholders and a board of directors, both of whom have clear incentive to be solvent. When a company fails, shareholders lose their investment and directors usually lose their jobs. (Under US Chapter XI procedure, directors of the failed company can retain their jobs, which is an exception in bankruptcy codes of major countries. This lenient treatment in the US bankruptcy code has a perverse incentive to go bankrupt under certain circumstances.) The failed company is usually controlled by an administrator or a receiver of the estate appointed by the bankruptcy court.

On the other hand, the government of a defaulting country does not have a similar incentive structure. The ministers of a defaulting government do not lose their posts and the defaulted country cannot be managed by externally appointed administrators. If an automatic debt restructuring process were in place, there could be a perverse incentive to make use of this debt relief mechanism. If this incentive is perceived by the market, the borrowing conditions for LDCs may deteriorate, increasing the cost of financing for good performing countries.

New allocation of SDR and increasing capital flows to LDCs

John Williamson correctly indicates that LDCs have to generate perverse resource transfers to developed countries when they build up reserves. In

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order to alleviate the cost of reserve building, he advocates a large new allocation of SDR. However, since the allocation of SDR is proportional to the amount of quota, a very large amount of allocation would be required to satisfy the needs of reserve build-ups of LDCs. Moreover, since the allocation would be given to both good performers and bad performers, there is a large risk of moral hazard and excessive borrowing.

Since the primary objective of reserve holdings is to assure the convertibility of the currency, it is more appropriate to use the limited IMF resources to directly enhance the quality of LDC currencies. The LDC debt problem was aggravated by the lost convertibility of LDC currencies. It is necessary to distinguish two kinds of risk faced by creditors: the risk of exchange control and the risk of the project. In the 1980s, when many LDCs could not borrow in the international financial markets, there were still many viable projects in these countries if they were evaluated by their own merit. By maintaining the convertibility of their currency for current transactions and debt services, LDCs could have attracted more private investments and thus alleviated the debt problem. Even if some of the debt has defaulted, they could have been resolved by ordinary bankruptcy procedures.

The IMF can support the maintenance of convertibility of LDC currencies more vigorously. One possible procedure would be as follows; the IMF gives a very generous stand-by compensatory and contingency financing facility (CCFF) in return to a very tight guarantee of the convertibility similar to the establishment of a currency board. By providing a solid guarantee of convertibility, private capital flows would increase. If the IMF observes that a country under this agreement is running an unsustainable policy, it can revoke the CCFF after a warning to the country. With this early warning mechanism, it would be easier to detect and rectify unsustainable policies such as excessive external borrowings or large budget deficits at an earlier stage. If BIS capital rule can be tied to this facility by giving a lower risk weight for those countries with this agreement, bank loans would also be encouraged. The IMF sometimes states that it should not become a rating agency so as to secure confidential information of member countries. However, it already functions as a rating agency because when it starts to negotiate a programme, sooner or later, the international financial community knows it. Moreover, under my proposal, there is a clear incentive for the participating country to stick to the commitment, making voluntary compliance more attractive.

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Floor Discussion of the Williamson Paper

A Blueprint for G-7 policy coordination

The four proposals for reform of the international monetary system put forward by John Williamson excited lively debate. His first proposal on policy coordination among the main industrial countries, in particular, raised many comments.

Gerald Helleiner agreed that macroeconomic coordination among the major industrial powers was critically important, but felt these discussions should also consider spill-over effects on the broader global community.

"Coordination is a necessary condition," Delphin Rwegasira pointed out, "but by no means a sufficient condition to ensure that all the segments of the world economy are taken into account. How can we ensure that within this policy coordination the needs of the least developed countries are explicitly addressed?" Would it be sufficient to ask the IMF to do this job when it participates in G-7 discussions, he wondered. Or would it be better to broaden this group by including other countries (industrial and developing countries) as well? Hasn't the G-7 taken over the IMF's coordinating role and, in a sense, hijacked elements of international policy coordination? Shouldn't the IMF be strengthened to become the credible forum for this kind of discussion?

Stephany Griffith-Jones put in the thought that policy coordination among the G-7 would be good for developing countries, even if it wasn't targetted to benefit them, by the mere fact that it would lead to more growth of world product. Some participants suggested that the interests of the global community could be better fulfilled by merging Williamson's blueprint on G-7 policy coordination with the application to all countries of his proposed set of international rules for sound domestic policies.

"Both should be presented as one proposal and applying to all member countries of the IMF," said Henrik Fugmann. Williamson, however, thought the two elements of policymaking should be kept separate. First, he said, there is a need for mutual consistency of targetting among the major countries, which doesn't apply to smaller countries since they "adjust to a parametric world (G-7 is 60% of world product)." Second, it would be impossible to get policymakers of major countries to submit to serious criticism by representatives of minor countries.

Jack Boorman stated that it is not so much the coordination mechanism which is the problem now, but the lack of will. How do you get the G-7 to

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take into the fullest account possible the concerns of the rest of the world in their own deliberations? he asked, adding that it is not a shortfall of economic wisdom, but really a shortfall of will on their part. Leo Verwoerd expressed his concern about the G-7 coordination process resulting in world directorates instead of a system of shared responsibility.

Tom de Vries missed the necessary elements of "politics and realism" in Williamson's blueprint. It presented the G-7 members as "faceless" countries without a history or particularities, such as the United States' special position of privilege, he felt. "It has been stated that the burden of adjustment falls entirely on the deficit countries," he said. "But if one looks at the biggest deficit country of all, the United States, one sees it has been able to ignore this deficit endlessly because of its geopolitical situation and the size of its economy." De Vries felt that in a world of global capital markets it is of great importance that major countries have stable and predictable economic policies. "The very fact that the major country, the United States, does not have it creates tremendous uncertainty," he pointed out.

Age Bakker stressed that the interests of developing countries and the smaller industrial countries run parallel. According to him, they are both prone to the waves of the world economic environment and have an interest in the maintenance of a stable system, a system which "would exert discipline on the larger industrial countries."

Amir Jamal suggested that it might be a good thing to encourage clusters of countries to do their own internal coordination and then feed these into the global coordination effort.

Williamson agreed with this, seeing possibilities for pushing regionalisation further as a way of getting developing countries to negotiate on a stronger basis. He said the proviso would be the same as for the (negligent) industrial countries: don't put up walls against the rest of the world. He felt the best way of getting LDC representation into a G-7 level of policy coordination in the next decade would be to ask: What is the eighth largest country in terms of democracy and economy? What is the eighth largest economy of a functioning democracy which happens to be a low-income country? He was quite confident about the eventual success of such an approach, referring to the case of Russia. "Some time ago," he pointed out, "many people thought that it was inconceivable that in the next quarter of a century there would ever be a Russian invited in the G-7. Nonetheless, it happened shortly afterwards. The fact that last year Gorbachov, and this year, Yeltsin were invited makes it clear that the G-7 is not that closed."

He said he had not heard any serious criticism of the substance of his blueprint and reminded participants of its basic objectives: stability of the system, and a proper policy mix of fiscal and monetary policies. He welcomed Ariel Buira's argument about the need for reinstating fiscal policy as a short-

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run tool, encouraging surplus countries to take part in the adjustment process. "More restrictive fiscal policies around the world are what the doctors should be ordering now, but there's no doctor who's ordering it in a way the patient takes much notice of, and that's what one is trying to address."

Williamson liked Mitsuhiro Fukao's suggestion that one way of keeping discipline among the powerful countries was through international financial regulations. An international body, he thought, could determine the level of reserves which banks (and other financial institutions) have to hold against loans. "This seems to me the right type of pressure to use," he stated. "It's something that's well worth pursuing."

However, he rejected Fukao's suggestion that policy coordination had led to the asset price bubble in Japan. Perhaps the 'easy money' policies had contributed to it, he said, but that could not be convincingly attributed to policy coordination. In this context, he would be in favour of making asset market control a part of economic management. "I am all in favour of target zones for stockmarkets too," he said, "which have to be wider than for exchange rates because we know even less about what the fundamental values are."

While agreeing that there was need for some mechanism to represent the interests of the world at large, he did not see an instant solution to this problem. "Maybe having the IMF there isn't adequate to do that task," he said. "But I don't think you can do it by tripling the size of the G-7. I certainly don't think you can do it by introducing China into the G-7. Above everything else the G-7 are the leading industrial democracies, and the word 'democracy' is absolutely central. I leave it as an unsolved problem."

An International Debt Restructuring Agency

Williamson's proposal that an International Debt Restructuring Agency be established got a rather cool reception.

Boorman felt such an agency would have been helpful in the early stages of the debt crisis when it might have sped up the recovery process, but now he doubted whether it would contribute to a more responsible and realistic relationship between lenders and borrowers. He would prefer an attempt at imposing "discipline in the market", he stated, discipline on the part of the macroeconomic policymakers to keep the global environment sensible, and discipline for the individual creditors to lend responsibly. According to him, bad macroeconomic policies in the 1970s, creating a shift from negative to positive real interest rates in the United States, was the single most important exogenous shock that caused the debt crisis.

Boorman was afraid that the Agency proposed by Williamson would give

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the wrong incentives. "Banks should be allowed to fail," he said, "there should be as little bailing out as possible. That's where our discussion really does need to go."

Griffith-Jones added that introducing such an agency now could have a disincentive effect. "If I were a private investor or private bank and I saw that this facility existed, I would automatically not put my money in any low-income country because you have this criterion which says that if you are a low-income country we will help you to restructure your debt."

However, she supported Williamson's idea of establishing international criteria for debt relief. "The criteria mentioned by John Williamson could be very useful in things like the Paris Club," she said, "where the conditions that very poor countries in Africa are getting are still worse than those for Poland. Having rules and criteria of the kind John is sorting out, is terribly useful." Like Helleiner and De Vries, she saw the proposed Agency being applicable mainly to official creditors (the Paris Club) rather than private creditors.

John Williamson explained that indeed debt was a war that was over. Nonetheless, he argued, there were still some quite important bits to be cleaned up from the last war, and maybe the proposed Agency could help, possibly by including Paris Club debt as well. However, the basic thrust of his proposal would remain, "preparing to avoid the next war".

International guidelines

Williamson's proposal that a set of international rules be agreed, limiting the freedom of countries to act against their own long-run interests, was widely supported.

Helleiner interpreted the proposal as "reinventing the IMF". In this respect, he thought it would be appropriate to make all IMF advice on sound macroeconomic policies public, "since there are few other levers that can be deployed". He said it would be particularly appropriate in the case "where the functioning of the entire globe rests upon the performance or malfeasance of major industrial powers".

Boorman, however, had some problems with the publicity aspect. On the one hand, he feared that the confidential relationship which the IMF now has with many of its member states might be called into question as it would become a kind of public credit rating agency. On the other hand, he doubted whether the players involved in the capital markets would pay any attention to what was published. Boorman also signalled asymmetry in the operation of the IMF: countries who don't borrow from the IMF are free to listen and to take its confidential advice, but countries who do borrow face different kinds of constraints.

Henrik Fugmann agreed with the purpose of what he called "guidelines for

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prudent policies". But he was strongly opposed to any criteria with respect to exchange rate matters and excessive demand. "It is impossible to get agreement on those points," he said. Fugmann strongly advocated a limiting of guidelines to objective criteria like debt to GDP and deficit to GDP.

Age Bakker stated that it would not be so difficult to agree on principles of good internal policies such as avoiding excessive deficits and maintaining price stability. The problem he saw, however, was that these rules on sound internal policies would not be adhered to "because countries see their interests differently". He drew attention to the European situation where policymakers were trying to formalise these rules.

"We have put them in the Maastricht Treaty," he observed. "You may argue about the numbers (limiting the budget deficit to 3 per cent of GDP and the national debt to 60 per cent of GDP), but they provide a yardstick for discussion and have teeth, because countries who would not live up to these rules will not be allowed to join the Economic Monetary Union."

De Vries liked Williamson's rules very much, and was optimistic about their possible success. He compared the application of such rules to joining the weightwatchers club. "You will do what is good for you in the long run," he said. "You will not indulge in the short run, and if your intentions flag then your peers come along and say, 'you have to stick to your intentions'". Since the weightwatchers seem to have some success with their technique, he argued, it might also work well in the field of international policy coordination.

Leo Verwoerd thought it was a good idea for the heavyweights to join such a club, "as a demonstration for the others, a kind of benchmark". He warned, however, against optimism about Europe's Maastricht Treaty being a possible model for the world at large. It was hard to get agreement, he said, and in the end the signing of the Treaty was only possible because of the political cement, the common political goal of these countries. So it would not be likely that it could be transplanted to the rest of the world.

Resumption of SDR allocations

A mixed reaction greeted Williamson's proposal for a resumption of SDR allocations to allow developing countries to increase their reserves without making a reverse transfer of real resources to industrial countries.

Age Bakker foresaw reluctance on the part of the industrial countries to such a proposal, because these allocations would oblige them to accept SDRs as well. If you look at the past, he pointed out, you see that developing countries have not retained these SDRs. Currently, their SDR holdings are nearly nil, which means that they have been accumulated in the industrial countries where they changed the composition of reserves. So, Bakker concluded, a resumption of SDR allocations would for industrial countries imply "accepting them for double the amount".

Boorman underlined this doubt. "You can provide these resources to developing countries, but how do you get them to hold them?" he asked. Under the Fund's Articles, he pointed out, one would have to allocate SDRs to all members on a quota basis, "which means you don't get the right level of reserves to each individual country". Moreover, he saw inherent problems in Williamson's suggestion that revealed desires for reserves over the previous five years be used as an indication of the proper level of SDRs needed. If this period had been one of reserve stringency, he argued, then it would not yield the correct figures. Because of all these difficulties, Boorman wondered whether it wouldn't be just as easy (or difficult) to increase developing countries' access to SDRs through a general quota increase. "The basic question is: are you using the most efficient mechanism to achieve the aim that you are looking for?" he stressed.

Fugmann did not object to the idea of using SDRs as a confidence-building mechanism, "as long as allocations are made at a moderate scale". But, he added, any proposal to have SDRs allocated by a different system than embodied in the Articles would create a problem. He saw a basic choice between keeping the SDR as a reserve asset or changing it into a means of transferring real resources. "That is the choice you have to make," he argued, "you can't have both."

Helleiner didn't see SDRs as the most useful way of answering the liquidity needs of developing countries. He would prefer to expand the capacity to provide (low interest) compensatory financing on a much more general scale, he stated. Williamson agreed that this idea might be a starter now. "There were always good intellectual arguments for that," he said, "and the fact that an attempt was made to extend the compensatory financing facility into contingency financing suggests that it might again be a promising line to think of."

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Summary of Workshop Discussion

Percy Mistry

A rule-based system

The sense of the discussion, if not a summary of it, was that John Williamson's diagnosis on the four core problems was quite sound, even if many participants felt it was somewhat partial in its coverage; a point which Williamson himself acknowledged. Williamson pointed out that it wasn't his intent to consider the International Monetary System (IMS) *and* the development financing system. That position causes me some concern especially if capital transactions involving LDCs and aid flows (which, in fact, in so many countries are substitute for the capital transactions) should not be a part of our consideration. If one talks about an IMS as looked upon by the people who really benefit from it and then leaves out the developing world, one disposesses a very large part of the world.

John Williamson's four points, which a lot of people have picked up essentially as three points are: first, policy coordination; second, what I would call APSID (Agency for Prevention of Self Inflicted Damage); third, DRA (Debt Restructuring Agency); and fourth, SDR allocations. If one really believes in a rule-based system which applies to everybody, one would merge policy coordination and APSID into one. But if one accepts, as John actually does, that the system is going to be (in real political terms) a different system for the issuers of reserve currencies and the users of reserve currencies, we should keep them as separate points. For a practical, real system to work it may very well be that we just have to accept that to a certain degree the G-7 (or G-3) deserves a right to impose or disobey rules applying to itself, whereas it may wish to be much more uniform in the way in which it applies those rules to others. Indeed, there may even be a distinction in the way those rules are applied to the other OECD countries, the NICs and the rest of the developing world. It's a problem of what I would call "dentures vs. teeth": basically the teeth are there to bite those who can be bitten, but they have to be removed when it comes to those who can't. Nevertheless, it would be nice to come up with a monetary system which really was rule-based, in which the individual proclivity to depart from the rules would be self-regulated.

John Williamson's prescriptions were generally found to be very useful from the point of view of generating a discussion. But opinions do remain divided both about their utility, the extent to which they really meet the problems that he has identified, and to the extent to which they are

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practicable. It was the general sense of the meeting, that one cannot seriously talk about an IMS (at least in a gathering which includes developing countries) without building in the requirements of development finance - especially if the developing countries are to be integrated into a well articulated IMS. Some of the implications of what was said, seemed to be that it didn't really matter whether developing countries were or were not integrated into the IMS, because in terms of global capital and money flows they didn't really matter all that much anyway. One can sympathise a great deal with the obvious reactions to that kind of implication.

Four key points

The four key points made during the discussions were, first, the need for adequate reserves, liquidity, and the restoration of creditworthiness without resort to continued massive net negative transfers; this was one set of issues in the development financing question. Second, the need for long-term development financing. Here both Henrik Fugmann and Gerry Helleiner seemed to be saying the same thing, but from an opposite side: why didn't we spend more time discussing the roles of the World Bank and the regional development banks? The third point concerned the need for much larger amounts of compensatory financing to meet exogenous shocks. Here I have a personal observation. There are two kinds of exigencies, one is a genuine "act of God", and the other are the kinds of "acts of men" which are inflicted on the defenseless. I do not believe that volatile movements in interest rates and exchange rates are "acts of God". Even if they are exigencies that other countries have to cope with, the whole purpose of an IMS is to equilibriate them out. If one group of countries decides in its own interest to inflict damage on another group of countries, either deliberately or accidentally, then the system ought to have some equilibrating mechanisms to help the others adjust. So we need to realise that exigencies really do fall into these two categories. The nature of an IMS has to recognise that very important distinction. The fourth point is that in building the requirements of development finance into discussions of an IMS, one really has to talk more about the roles of the multilaterals and regionals.

Let me elaborate a bit on the last point. Implicitly, when we have talked about the IMS, we have tended to talk about it as if we have taken for granted that the IMS must be built around the structural vestiges of a system that, in my view, is already dead. Bretton Woods is dead and gone - John Williamson has made a very powerful case for that - but its two orphans, the IMF and the World Bank, live on. They actually are grateful that exigencies arise to give them a role. Frankly, they have not done all that well in managing these exigencies. There were of course the oil shocks and the energy crisis in the

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1970s, and the debt shock and the adjustment crisis in the 1980s to give these agencies something to do. In the 1990s the collapse of communism has extended their lease on life and given them a new purpose. But a balanced opinion, taking both creditor and debtor sides into account, would probably come out with the conclusion that there has been a net welfare loss to the global system, partly as a result of the way in which these two agencies have operated. Reality may very well be that, if they hadn't existed, they would have been invented. But whether they would be invented with all the baggage that they carry, for me is really an open question.

If we're living in a market-driven world, whether in fact we need this kind of interventionism by the international financial institutions (IFIs) raises some rather fundamental questions. For instance, can't some of the things they do be done more efficiently by using markets and by finding other, much less costly mechanisms to cover risks which the market is unwilling to cover. We cannot just automatically assume that because they're there, a system must be built around them. The "real" roles of the IMF and World Bank is an important agenda for research in the future. We should not help inventing exigent roles for them - which take them far away from the intent of their founders - simply because they happen to be there.

In other words: What do we do in terms of the possible roles of these institutions? Gerry Helleiner's point about the importance of the regional development banks is a very good one. What aspects of the roles which the staffs of the IMF and World Bank are unwilling to change must be changed? What do we add to roles which ought to be performed, but which are not being performed? And how do we build agencies like BIS more closely into the network of IMF, World Bank, etc.? For there is a role that BIS very quietly plays on its own, which actually overlaps quite substantially with the roles of the IMF and the World Bank.

Missing links

The fifth broad set of points is what Helleiner has called 'missing links', which have come up more en passant than deliberately. They basically fall into four parts, one part partly going to be a repetition of what I have already said.

The first is this whole question of an excess burden of adjustment (and we almost take it for granted now) falling on deficit countries, except the largest reserve issuing country. Also, in a market-driven regime (in which taxation and fiscal policy seem to be off the agenda for discussion) the burden of adjustment inevitably falls entirely on the interest rate and the exchange rate. We may have reached the point where those two tools simply cannot bear the weight; the IMS may need some element of fiscal policy coordination as well in order to function properly.

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The second question opens up a broad agenda of issues which fall into a category of what I would call 'regulatory concerns', to ensure that virtuous cycles of net inflows do not rapidly turn into vicious cycles as in the past. This is something Stephany Griffith-Jones' paper was useful in portraying; it asked the question, but it seems much too premature to provide an answer. It's very clear from what both John Williamson and Stephany Griffith-Jones have said that the answer to the distinction between virtuous and vicious cycles of capital flows lies very clearly in both the institutional mechanism and the efficiency of regulation. Although the BIS has moved further than most others in setting up capital requirements for banks, the exchange markets, commodity markets, OBS liabilities markets and securities markets still leave a lot to be desired in terms of regulatory lacunae; the flows in these markets are extraordinary large.

The third question is the issue raised by John Williamson of the role of reserves in an environment where creditworthiness and credit standing rather than the quantum of reserves determine access to global liquidity. How do we trade those two off? To what extent are reserves themselves an indicator of creditworthiness? And to what extent do borrowed reserves really amount to real reserves?

Let me give you an appropriate case: In 1991 India's reserves dropped in nine months time from a healthy \$9 billion to a very unhealthy less than \$1 billion, as \$5 billion worth of non-resident deposits departed the country, both because of political instability and bad policies. Since then, reserves have been built up to \$4 billion, entirely as a result of World Bank and IMF intervention. Frankly, much to the credit of the Indian community, no Indian seriously regards these as reserves, because they know that if they draw them down it's curtains for the country. And I am amazed that in the international community the general feeling is that India's creditworthiness is now restored, because of its reserves. This issue of reserves and creditworthiness is an area which therefore needs some very careful looking at.

The fourth point is the question of the underlying problem of constructing an IMS which has an inherent balance of power between those who issue reserve currencies (not all of whom are necessarily surplus countries) and those who use reserve currencies. But there is a secondary aspect to that concern: in the last ten years the users of reserve currencies in the system, primarily the deficit countries minus the USA, have legitimately been concerned about the extent to which the IFIs themselves have been used to amplify the burdens of adjustment and to exacerbate them rather than ameliorate them. In fact the large net transfers from the developing world to these institutions have now become a large part of the problem and no longer a solution, and thus raise some fundamental questions both about their functioning and about their structure.

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The aid enterprise

A final personal point about development aid. The discussion with Arjun Sengupta did raise the issue of development financing, the constituency for aid, and the question of how to rebuild that constituency. I've been grappling with this since I was personally involved with and responsible for IDA funding negotiations (when I worked at the World Bank). The first time I came across the phrase 'aid fatigue' was when I read some documents dating back to discussions in 1956. I seriously believe that in a market-based regime the ability of the world to tug at the world's heartstrings on the grounds of progressive taxation, and social justice, etc., has reached an absolute limit, mainly because of widespread misperceptions of large scale abuse of aid. It is true that there has been abuse of aid, but if you look at the whole field of public endeavour as Bob Ayres has put it, it is fair to say that the aid enterprise has probably performed with greater efficiency and less corruption than defence, public works, education or health care. One needs to look at aid in a relative context. The fact that $4 billion out of $50 billion may be misappropriated is certainly a cause for extreme concern. But my own feeling is that the real theoretical and conceptual justification for what I no longer wish to call aid, but must be called 'necessary resource transfers', is rooted in market theory itself. To the extent that developed countries choose to protect lifestyles and choose to deliberately distort international markets in a way which causes damage to developing countries, the theoretical, conceptual and legal case for compensatory offsets becomes a very powerful one. My own feeling is that the only theoretically and conceptually respectable rationale for aid is a rationale which is based on compensation for market distorsions, rather than humanitarian or moral (which I hope will continue to flow). But I think that humanitarian aid may flow better through churches and NGOs rather than through governments per se. If, in fact, this market-based regime is to prevail, the sooner we legitimise the idea of resource transfers on the basis of market distorsions (in some instances these are quite easy to calculate) the better. Such a calculation would be much easier to defend than the 0.7 per cent of GDP or an international income-tax mechanism.

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Appendix

List of Participants to the Workshop on the Functioning of the International Monetary System, The Hague, 9-10 June 1992

Mr. Shahen Abrahamian	Chief International Monetary Issues, UNCTAD, Geneva
Mrs. Theodora Antipas	Vice-President, Chemical Bank, London
Mr. Dragoslav Avramovic	Director, European Center for Peace and Development, Belgrade
Mr. Robert Ayres	International Economic Relations Division, The World Bank, Washington
Mr. Age Bakker	Manager, International Affairs Department, De Nederlandsche Bank, Amsterdam
Mr. Horst Bockelmann	The Economic Adviser, Bank for International Settlements, Basle
Mr. Jack Boorman	Director, Exchange and Trade Relations Department, IMF, Washington
Mr. Ariel Buira	Director, Banco de Mexico, Mexico
Mr. Giovanni Andrea Cornia	Director, Economic and Social Policy Research Programma, UNICEF, Florence
Mr. Mohamed A. El-Erian	Division Chief, Middle Eastern Department, IMF, Washington
Mr. Ricardo Ffrench-Davis	Principal Regional Adviser on Economic Policy, ECLAC, Chile
Mr. Henrik Fugmann	Deputy Permanent Secretary, Ministry of Economic Affairs, Denmark

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