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The Lack of Stable Capital Flows to Developing Countries

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I want to make two short caveats before I start. First, the title of this session is "Fostering Global Financial Stability", and I think we should change it into "Fostering Global Financial Stability and Growth", because we need to think about how the global financial system can provide both important public goods. It is often forgotten in the discussion that the ultimate aim is growth and employment and so on, although of course such aim is embedded in Article 1 of the IMF.

The second caveat is that it was surprising that so much of the discussion has been at the national and regional level, important as these are, because the traditional Fondad focus has always been on the global level, and there has been a lot of pioneering discussions in Fondad meetings. Rather than being a criticism, I would urge Fondad to continue in this tradition.

We have had a very interesting discussion, certainly at the regional and the national level, and before I go to the international dimensions, I just want to make a point about Argentina. We have not really learned lessons. In the current Argentina crisis there is much in common with what happened in the early 1980s: short-term foreign exchange liabilities, fixed exchange rates, and so on. So we have to ask the question, all of us, at the national and international level, public and private: how can we learn from experience and how can we transmit this experience, so that we do not have another crisis again in ten years which looks exactly the same.

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Going to the issue of the pursuit of international financial stability, there are two aims. The first is the pursuit of financial stability *per se*, that is, the agenda of crisis prevention and management. The second is the provision of sufficient capital flows, both private and public, to different categories of developing countries to help sustain growth.

The Pursuit of Financial Stability

On financial stability, we concluded that progress has been insufficient, asymmetrical and also that there have been important reversals. I want to talk a bit more about the reversals. One of the reasons – I don't know if it is the main one, but certainly it is a very important reason – why the Argentinean crisis was so deep and has continued for so long, is that there has been a reversal in international financial governance. The Argentinean crisis happened to occur at a time when the developed countries, and particularly the US, became unwilling to continue large IMF lending packages to manage crises and, at the same time, there was no framework for orderly debt workout in place. Argentina was just very unlucky; it had a lot of its own problems, but it happened to fall in a 'lacuna', or institutional vacuum. Yung Chul Park was complaining that it took Korea ten days to sign an agreement with the IMF; six months after the start of the Argentinean crisis, there is still no agreement.

Argentina's difficulty in obtaining IMF lending has to do with an overstating of the problem of moral hazard. Moral hazard is a problem, but I don't think that financial markets' exuberance is only due to the fact that the IMF lends. Because we have had lots of crises, starting for example here in the Netherlands with the tulip crisis in the 17th century, when there was no IMF and the markets were still very exuberant with boom-bust patterns and so on. So we should not overstate the problem of moral hazard.

Two points on why the IMF has been so slow. There is a parallel with East Asia. The IMF has demanded a number of structural reforms from the Argentinean economy. Many of them are probably necessary. But it is not a good moment to do structural reforms in the middle of a crisis. You first have to deal with the crisis and then you do the structural reforms because they take a lot of time and are particularly difficult to do in a crisis. This is a point that we discussed during the Asian crisis. The IMF itself recognises this mistake in some documents it has produced, but it is not applying the lessons. The second point, which was also recognised in this nice evaluation the IMF did on East Asia, is that you have to be careful how much fiscal adjustment you require in times of crisis. Because when there is a dramatic fall of GDP, this leads of course to great difficulties in tax collection and getting enough fiscal revenues. Therefore, if you are too demanding, you deepen a recession.

On other issues of progress in international financial reform, I just want to make the point that a number of people – particularly colleagues from Asia – have talked about the lack of a global financial regulator. There has been a quite brave step in the creation of the Financial Stability Forum and other attempts, but they are weak and they don't represent developing countries. Yet this attempt to improve global financial regulation is important because, however one might want to criticise the IMF and other institutions for being insufficiently democratic, one of the deepest flaws in democracy – also something I learned in a Fondad meeting – is the lack of accountability of markets. There is no democratic accountability, and the only, very technocratic, way of doing it is through regulation.

The Provision of Sufficient Capital Flows

I want to talk about a second area of concern. We used to complain about the fact that we have too much volatile capital flows, and some are still talking about it. But the key problem that most developing countries at the moment are facing – not Eastern Europe – is the lack of sufficient capital flows. And having criticised the IMF, I will now use their data on capital flows to developing countries because they are the best ones we have. If you look at the build-up during the 1990s of net capital flows to emerging markets, you see that they peak in 1995-96 at more than 200 billion dollars, then they fall sharply, and they have stagnated for the last five years at around 60 billion. This is a dramatic fall and I think the next crisis may be the result of insufficient flows. We have to start adapting the discussion and the understanding of policies to this new reality.

A first question to ask is: Is this just a cyclical thing? Is this the memory of the recent crisis, the slowdown of the US economy, and so on? Is it just a cyclical reversal that will go away with time? Or are there important structural elements? I think there are important structural elements, which I will go through quickly.

One is the fact that banks have crossed the borders and prefer to lend in local currency, and therefore lend less in foreign exchange. Another, and worrying, structural element is that one of the few regulatory changes that have been pursued is the revision of the Basel Capital Accord. That revision may actually institutionalise the unwillingness of banks to lend to developing countries because it is going to use banks' own risk models to determine the level of capital requirements. And by using the banks' own models, it will make high risks more costly. As developing countries are perceived as high risk, they will have to pay more. Second, it will make lending even more pro-cyclical. In equity and bond markets there is a problem that, to the extent that these flows are increasingly going to the private sector, people in the market are saying, that there are not enough suitable borrowers or companies to invest in because they have either been privatised or they have been sold to foreign investors, and in some small or low-income countries there are just not a lot of large companies. These days it is very hard to find fund managers specialising in emerging markets or particularly in low-income countries like Sub-Saharan Africa. There seems to be a greater recourse to global fund managers investing a little bit of their money in emerging markets, which makes it – as a recent IMF report pointed out – more unstable because investors move very easily. When they see problems in emerging markets they pull out their one or two percent which they have in those markets very quickly and put it back in US or European paper. You don't buy to hold, these people say, it is more the case that you buy and sell all the time. The intention is increasingly short-term, except for FDI, which is the only good and important part of the story.

So the question is whether the presence of foreign companies, banks and other investors brings the developing countries the foreign exchange they need. If the capital flows do not come then the whole point of making efforts to attract private flows through liberalising the capital account and privatisation would be quite futile because you would only get the expertise – which is important – but you would not get the complementary foreign exchange. Therefore, a new challenge for the international community is to design measures – both in the receiving countries and in the source countries – on how to encourage sufficient stable flows to developing countries.

How can we mix public and private guarantees, possible subsidies, tax incentives and so on, both globally and regionally, to try and encourage sufficient flows to developing countries?