

Executive Summary

- 1 Private capital flows to developing countries, after declining in the 1980s, increased dramatically to unprecedented levels in the first half of the 1990s. However, these private flows remain highly concentrated. There was a particularly sharp increase in international portfolio investment. The absolute size of foreign direct investment grew very rapidly but the relative importance of bank lending to developing countries fell drastically.
- 2 Capital inflows are important to developing countries because of their role in financing investment which contributes to long-term development, and/or in shorter-term smoothing of consumption. However, surges of inflowing private capital can create macroeconomic problems, particularly through their effects on either the exchange rate or the domestic money supply, together with the risk of their abrupt cessation or outflow. In many developing countries where there are relatively weak domestic financial markets, there are likely to be further difficulties created by surges of external private capital, either inward or outward.
- 3 Increasing numbers of countries have opted for full capital account convertibility and integration with global capital markets. The principal gains from capital account liberalisation at the national level and from global financial integration, more generally, are those deriving from the increased efficiency of both national and global capital markets that they can create. But greater integration and capital account liberalisation also involve risks.
- 4 In the 1990s, capital controls have frequently been motivated by the desire to stabilise the domestic economy in a world of volatile private capital surges. It is critically important for development that countries maintain a stable and appropriate real exchange rate, a stable and sustainable current account, and a reasonably stable macro economy. For this purpose, it may be desirable to moderate overall capital flows that are not driven by long-term economic fundamentals, in order to encourage a better balance between long and short-term capital flows.
- 5 Direct regulation of international capital flows, both inward and outward, has been common in developing countries. Of the 155 developing countries surveyed by the IMF, 119 employ some form of control over international capital flows, although 75 have accepted Article VIII obligations in respect of the current account. The forms of these controls are numerous and the degree of their use varies greatly both across countries and over time. Some may be motivated more by the need to monitor than the desire to restrict.
- 6 Some forms of external private capital inflow are more attractive to the recipient country than others. From the standpoint of future macroeconomic stability, the longer-term and more stable inflows of capital are better. Categorisation of portfolio capital flows, however, is often difficult. Long maturity external obligations may seem, in principle, less vulnerable to volatility than short maturity ones; but if there are active secondary markets, long maturities may be highly liquid. Monetary authorities in some countries have nonetheless found it possible to encourage

longer-term bank deposits and longer-term credits via carefully structured bank reserve requirements and “minimum stay” regulations, respectively.

- 7 Foreign direct investors are presumed to base their decisions on longer-term economic and political fundamentals and, hence, to be less volatile in their short-term behaviour; but in certain cases, foreign direct investment flows can also be volatile as transnational corporations manage liquid funds as well as flows of real goods and services.
- 8 It is well-known that controls over capital outflows are difficult to enforce. But it would be inappropriate to conclude that controls are always ineffective, provided they are used sparingly and are not intended to mask fundamental imbalances. The issue is usually whether the social benefits of such controls warrant their administrative and other costs.
- 9 Many East Asian and Latin American countries appeared remarkably successful in responding to surges of private capital inflows in the 1990s through a judicious combination of exchange market intervention, monetary sterilisation, fiscal discipline, and the careful and changing use of direct controls on both inward and outward flows to dampen volatile short-term movements.
- 10 To the extent that private international capital flows are subject to volatile behaviour that does not accurately reflect “fundamentals”, there is a case for the provision of emergency official credits to developing countries facing large and sudden capital outflows. During the past year progress has been made towards improving early warning systems via sharpened data systems and through the establishment of an emergency financing mechanism financed by a significant expansion in the General Arrangements to Borrow. The key issues for the construction of an effective mechanism for the provision of official finance in response to the problems created by disequilibrating private capital flows are: (i) the criteria for judging the eligibility of countries for such assistance; (ii) the need for speed in response; (iii) the size of the resources to be supplied, where they might come from, and through which channels; and (iv) the appropriate maturity on the credits, the upper limits upon individual country access to them, and the need to provide them on a longer-term basis in some instances.
- 11 Financial crises in developing countries may also reflect more fundamental problems of “solvency” that cannot be addressed solely by the provision of increased liquidity. External financial support can be essential for the success of efforts to reform and restructure fiscal, financial and macroeconomic management systems. Its objective must be to assist governments and countries to restructure themselves with minimum social cost and to do so in such a way as to minimise moral hazard. A recent G-10 report has argued for the introduction of new provisions in future international debt contracts (loans and bonds) that clarify the means of collective representation and decision-making on the part of creditors, and thereby facilitate future orderly workout of sovereign debt problems. However, the report sees the adoption of these changes as a market-driven process. But this is unrealistic and there are significant obstacles to market-driven reforms. Also, in the absence of a lead by G-10 governments to introduce changes in their contracts, any developing country wishing to pioneer the proposals would be taking a risk with market perceptions (see the Note on Insolvency and Sovereign Debt Workouts in the Annex).
- 12 The IMF should be formally mandated to lend into financial crises in developing countries, both to provide emergency liquidity and to support orderly workouts of sovereign debt problems. For this purpose, it should be provided with significantly expanded resources,

particularly through quota increases and SDR issues. The longer-term nature of the reform and restructuring processes involved in orderly debt workouts, and the potential need for more sizeable external resources than the IMF, by itself, is able to provide, suggest an important complementary role for the World Bank.

- 13 In recent years, the IMF has actively promoted capital account convertibility for all of its members. Notwithstanding the eventual advantages of an open capital account, it is generally agreed that there may be difficulties in the transition and that some sequences of policy reform make more sense than others. It is clear that capital account liberalisation for a great many developing countries will be a long-term process. Moreover, even in countries which have liberalised, temporary controls will continue to be an important tool for responding to private capital surges which create macroeconomic problems. It would therefore seem premature to consider an amendment to the IMF Articles of Agreement that required all members to commit themselves to the achievement of an open capital account.
- 14 Section 1 of Article VI prohibits the use of the Fund's general resources "to meet a large or sustained outflow of capital" and authorises the IMF to require members "to exercise controls to prevent such use". The capital outflows to which future IMF loans are likely to have to respond may be "large", "sustained" or both. It would be wise to attempt to clarify the IMF's role and responsibilities in future financial crises. The IMF should be encouraged to expand its role, in conjunction with other relevant bodies, in the surveillance of international capital markets. Monetary authorities in the developed countries should also actively assist and co-operate with those in developing countries in the collection of data, monitoring of developments, and, in inappropriate circumstances, in the implementation of controls on international private capital flows.
- 15 Rules and regulations relating to international capital flows are not the same thing as rules relating to foreign financial institutions or the services they provide. The IMF has rules relating only to the latter. Early efforts should be made to clarify rules and jurisdictions relating to international capital account transactions and international financial institutions in the many areas in which there are potential overlaps.
- 16 It is also important that major industrial countries take account of the increased sensitivity to interest rates of private capital flows to (or from) developing countries as well as the potential for significantly increased feedback effects from the developing countries' performance to the global economy.
- 17 Ten ideas for improving the adequacy of existing international arrangements are set out in the Recommendations at pages 21 and 22 which Ministers may wish to consider.