

Improving International Arrangements

The Provision of Liquidity in Response to Capital Surges

- 56 To the extent that private international capital flows are subject to volatile and herd-like (“disequilibrating”) behaviour that does not accurately reflect “fundamentals”, there is a strong case for supplementing national action with supportive international arrangements. Recent analysis has however not said much about the possibility of increased direct co-operation, for the purpose of more effective macroeconomic management, between the monetary authorities of the capital-losing and capital-gaining countries. This is somewhat surprising since there are evidently considerable under-exploited opportunities for such mutual assistance (see, for instance, Felix, 1993). Some such co-operation takes place bilaterally on an ad hoc basis and, among the central banks of the major industrial countries, in the activities of the Bank for International Settlements (BIS). Except in emergencies, such as those of Mexico in 1982 and 1994+95, however, little direct co-operation is found normally between Northern and Southern monetary and financial authorities.
- 57 For some years there has been discussion of means for the provision of emergency credits to developing countries facing large and sudden capital outflows that are not associated with changes in domestic economic fundamentals. It is easy to envisage circumstances in which the changes in interest rates and/or exchange rates that would be required in the capital-losing developing country to restore capital market stability are impossible or undesirable; or in which there is a prospect of major defaults on external debt; or in which there is a risk of inappropriate and internationally damaging intervention via controls or taxes on international transactions. In such circumstances, there is a strong case for official intervention in the form of the provision from abroad of official credit to offset the disequilibrating flows.
- 58 In order to be effective and, in particular, to serve as credible “signals” to markets and as catalysts for other official sources, such credits would have to be provided in very large amounts and at very short notice. The 1994-95 Mexican crisis, described by the IMF’s Managing Director as “the first financial crisis of the twenty-first century”, and generating the largest IMF loan to a member in its history (both absolutely and in relation to its quota), demonstrated the urgent need for significantly improving upon current arrangements. During the past year progress has been made towards improving “early warning systems” via sharpened data systems, and towards the significant expansion, principally for this purpose, of the IMF’s General Arrangements to Borrow (GAB).
- 59 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 as follows: (i) the criteria for

judging the eligibility of countries for such assistance, including, for instance, upper bounds on prior current account deficits (expressed as percentages of GDP) adjusted to reflect different means of financing, previous debt loads, etc.; (ii) the need for speed in response, and therefore prior authorisation of later “automatic” access; (iii) the necessary 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, evident in the Mexican case, to provide them on a longer-term basis in some instances (Williamson, 1996).

- 60 Such credits are best provided through the IMF, so as to preserve a fully multilateral approach to such crises, and to buttress the role of the Fund in international monetary and financial affairs.
- 61 The new arrangements being constructed in this sphere build upon the IMF’s GAB. As long as they do not reduce the prospect for an IMF quota increase (and they might), these financing arrangements are likely to be additional. Developing countries have reasons to be concerned, however, about many elements of the emerging scheme for the provision by G-10 and other countries of increased IMF finance for crisis lending. In particular, there are grounds for doubt as to whether its resources will be sufficient, whether its procedures for determining eligibility and activation will be appropriate, or whether the new arrangements are likely to succeed in achieving their stated objectives. Developing countries have also expressed their concern over the unrepresentative decision-making processes outside the IMF employed in setting up the new arrangements (G-24 Communiqué, April 21, 1996, paragraph 11).

- 62 What is clear is that in the new world of volatile private capital flow, traditional measures of the adequacy of international liquidity, based primarily upon the relationship between owned foreign exchange reserves and imports of goods and services, are obsolete. Appropriate guidelines for reserve management in a world of large and volatile capital flow are unfortunately still nowhere to be found. Presumably, new guidelines would have to take account of stocks (of external debt, domestic money supply, etc.) as well as flows. The capacity of the IMF, with current resources, to address the likely liquidity requirements of emerging markets in coming years remains very much in doubt. Increases in IMF quotas and further SDR issues are minimum necessary steps in the rebuilding of a credible multilateral liquidity system.

Orderly Debt Workouts

- 63 The experience of the 1980s has demonstrated that financial crises in developing countries may also reflect more fundamental problems, problems of “solvency” that cannot be addressed solely by the provision of increased liquidity. In the absence of an agreed international framework for dealing with these more fundamental solvency problems, the “workouts” have been slow, ad hoc, and consequently socially costly and often inequitable.
- 64 Whereas within national jurisdictions, bankruptcy procedures provide the legal means for reducing the inefficiencies and inequities that can be associated with such workouts, there are no such agreed arrangements for sovereign debtors in international financial markets. There has been increasing recognition by governments that improvements in current international arrangements are both desirable and

possible (e.g. Sachs, 1995a and 1995b; Eichengreen and Portes, 1995; Group of Ten (G-10), 1996). Many private financial institutions continue to oppose such reforms, no doubt believing that eventual governmental bailouts are a brighter prospect for them than officially sanctioned writedown of sovereign debt.

65 Where financial crises have “fundamental” origins, there can be no substitute for reform, restructuring and improved (and usually changed) management. 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 minimize moral hazard. Sachs has stressed the need for financial assistance at three critical points in a debt workout: a standstill on debt servicing obligations at the outset; “fresh working capital during restructuring, so that critical governmental functions don’t collapse” (1995a, p. 20); and eventual debt reduction to assist in the restoration of solvency (1995a and 1995b). At each of these points there are severe collective action problems in that individual creditors have little incentive, by themselves, to assist. Hence many see the need for a significantly enhanced role for a multilateral financial institution like the IMF to establish appropriate principles, set the conditions, and organise the financing for more orderly and efficient sovereign debt workouts.

66 The recent G-10 report sides with those (like Eichengreen and Portes, 1995) who have argued for the incorporation of new provisions in international loan contracts and bond covenants that clarify the means for collective representation and decision-making on the part of lenders and bondholders in the event (unlikely, they hope) of future difficulties with debt servicing⁵. (See the Annex.)

67 The G-10 report also suggests that the IMF could both signal its approval of a (unilateral) cessation of external debt servicing and assist in the provision of working capital by conditional lending to governments that have entered into external arrears. There is already precedent for such IMF practice in the case of arrears on bank loans. The new IMF financing arrangements discussed in the previous section can clearly be deployed in support of orderly workouts of sovereign debt problems as well as to provide emergency liquidity. As noted above, the details of such arrangements remain to be negotiated. Adding the support of orderly debt workouts to the financial responsibilities of the IMF, however, can only raise further doubts as to the adequacy of IMF resources for the effective performance of its role in the 21st Century.

68 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

5 However, unlike the case of bank debt where there is a reasonable assurance that workouts would be orderly because of central bank suasion behind the scenes, in the case of bondholders there is enormous uncertainty as to who the holders are and whether workouts would be orderly. Even if there is a change in bond contracts, the vast majority of existing bonds will for years carry the old contract language so that the new bonds would be subordinated debt and carry a much higher cost of issuing. Also, domestic financial instruments, such as the tesobonos which caused the problem in Mexico, would not be covered by these proposals. In addition, in the absence of a lead by G-10 governments to introduce changes in the contracts of their own bonds, any developing country wishing to pioneer the proposals may, by even raising the possibility of default, be taking a risk with market perceptions. Nonetheless, the measures should help to reduce the risks of extended negotiations with creditors and increase the chances that both borrower and lender share the burden of adjustment.

World Bank. In low-income countries, the development of joint IMF-Bank programmes based upon ostensibly locally developed policy framework papers already has a considerable history. Analogous approaches would seem to be appropriate for future debt workouts in middle-income countries.

The IMF and Capital Controls

69 Under the IMF Articles of Agreement (Article VIII)⁶, members are required to seek current account convertibility though by no means all have done so. Of the 125 low- and middle-income countries with populations of over one million, 53 have accepted the obligations of the IMF's Article VIII (see Table 5); of 50 full Commonwealth members, 42 have done so (Table 6). Under Article VI, however, members are permitted to retain capital controls⁷ and, as noted above, about three-quarters of them (119 of 155) do so.

70 In recent years, the IMF has actively promoted both current as well as capital account convertibility for all of its members, and it now reports upon capital controls in its surveillance of members' exchange rate policies and exchange restrictions. In a series of speeches in 1994 and 1995, the Managing Director of the IMF vigorously advocated capital account convertibility and floated the idea of revising the Articles of Agreement to promote that end, an idea considered in more detailed fashion in a recent Fund paper (1995d).

71 In Article IV consultations with industrial countries the IMF has generally been

strongly supportive of capital account liberalisation. In those with developing countries, according to a recent IMF survey of this subject, it has approached the issue of capital controls on a case-by-case basis; however, "the tightening of controls over capital movements ... was generally discouraged ..." The IMF survey speaks of "a general distaste for such controls as a way of addressing balance of payments difficulties", although "prudential limits on foreign exchange risk exposure have been endorsed" (IMF 1995d, p.6).

72 In its technical assistance, the IMF appears frequently to have been more forceful. "Traditionally, the IMF's technical assistance in the area of foreign exchange systems focused on efforts to facilitate current account convertibility in its member countries; however, from the mid-1980s the focus shifted toward encouraging the adoption of full capital account convertibility. Common themes in technical assistance supporting a move to capital convertibility have included the ineffectiveness of existing controls, improved transparency associated with a free exchange system, the benefits of recognizing an informal market through which a significant proportion of transactions was already taking place, and the need to develop a competitive and efficient exchange system." (ibid.)

73 More recently, the IMF appears to have modified its approach. A series of research papers and conferences have portrayed a more nuanced IMF position – to the effect that controls may serve some useful

6 Under Article VIII: "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions" (section 2) or "...engage in any discriminatory currency arrangements or multiple currency practices" (section 3). These Articles have never been amended.

7 Section 3 of Article VI of the IMF's Articles of Agreement states that "members may exercise such controls as necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments."

purposes, in particular circumstances, and when employed on a temporary basis (IMF, 1995d, pp.4, 6, and 22-23; IMF, 1995c). In late 1995, an IMF report argues:

“... during times of surges in inflows a country might consider measures to influence the level and characteristics of capital inflows, such as taxes on short-term bank deposits and other financial assets, reserve requirements against foreign borrowing, and limits on consumption credit. In this regard, the experiences of Chile, Colombia, and Malaysia have been revealing ... In countries facing large and potentially unsustainable capital flows, a mix of intervention, sterilisation, fiscal consolidation, and some direct measures to discourage short-term portfolio flows or to influence their composition may be appropriate. The mix of policies will, naturally, vary from country to country”.

(IMF, 1995b, p.27; *my italics*).

In its background paper (in the same document) it concludes, “In light of the recent experiences of countries that adopted measures designed to curb short-term capital inflows, it appears that, at least in the short run, the policies were effective in either reducing the volume of capital inflows or affecting their composition, or both” (ibid., p. 108). Even in the longer term, there seems to be IMF acceptance that liberalisation of the capital account will not serve its purpose if it is to be reversed subsequently.

74 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.

Generally, there seems to be agreement that domestic stabilisation and financial reforms (particularly the strengthening of prudential regulation and the creation of solvent and sound banking and financial institutions) are a prerequisite, or at least a co-requisite, for successful external capital account liberalisation (IMF, 1995d). If domestic banks or other financial institutions are fragile and weakly supervised, a large inflow of funds can be very inefficiently intermediated with the prospect of bubbles and future crises. It is also generally agreed that trade liberalisation should precede or, at least, accompany liberalisation of the external capital account. In some cases, reforms may move concurrently and with speed; but experience in the Southern Cone and elsewhere in the late 1970s and early 1980s illustrates the danger that underlying weaknesses in the financial sector can be aggravated and further problems created by premature and overly rapid capital account opening⁸.

75 On the basis of experience to date, reviewed above, it is clear that capital account liberalisation for a great many developing countries will be a long-term process. Moreover, since private capital surges have continued to create severe macroeconomic problems in countries that have ostensibly already liberalised, controls, albeit usually temporary, will continue to be an important part of the policy armoury for responding to them. 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.

76 If an amendment relating to capital account issues is required, it is most urgent in the anomalous provisions describing the IMF's

8 The World Bank has adopted quite similar approaches (see, for instance, 1996, p.11).

authority, under Article VI, to lend in Mexican-type circumstances. 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 "21st Century" financial crises. This may also involve, as argued by some in the IMF, expansion of its jurisdiction over "payments and transfers and multiple currency practices related to international capital movements. No other international agency exercises jurisdiction over such transactions" (IMF, 1995a, p.32). In light of the declining share of current transactions in total exchange transactions and the difficulty in distinguishing current from capital transactions, some argue that the IMF may be unable to pursue its broader responsibilities without such a modification of its formal jurisdiction (ibid., pp.31-2).

Other International Regimes

77 International regimes relating to capital account transactions can have a variety of purposes, e.g. facilitation of cross-border transactions (including harmonisation of accounting, disclosure or other regulatory standards), encouragement of competition in financial services, achieving and maintaining financial stability, etc. (White, 1996). 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 former. The WTO is among the multilateral bodies striving to develop a regime for the latter (Zutshi, 1995), but also active in

these issues are the BIS, OECD, EU, NAFTA, and other regional bodies. There is evidently considerable clutter, confusion and overlapping jurisdictions in the international regimes for capital flows and financial transactions. Are these various regimes mutually consistent? Are the needs of the developing countries different and are they taken into account? Many emerging market policy-makers will identify readily with the Dornbusch assessment that: "Liberalization of world trade in financial services is the most fiercely lobbied issue of the day" (Dornbusch, 1995, p.23). These issues urgently require more detailed and comparative analysis.

78 A further question relates to the potential role of regional agreements and institutions. Freedom of portfolio capital flow and (most) FDI is central, for instance, in the NAFTA. It is also obviously a key feature of the CFA franc zone. If the world economy evolves on a regionalised basis, as some predict it will, one could easily envisage large regions within which capital, as well as trade in goods and services, would flow relatively freely but between which some controls remained. Negotiations concerning future capital account regimes may thus be at their most vigorous on a bilateral or plurilateral (regional) basis, e.g., in the Free Trade Area for the Americas, or the APEC, or the successor to the Lomé Convention.

79 In some cases, as has been suggested for sub-Saharan Africa, such arrangements might increase the credibility of governmental policy commitments by providing an "agency of restraint" on governments with deficient "track records" (Collier, 1991). But such "opening", as has been seen, may be inappropriate or premature. It is also quite possible that the United States (or other reserve currency countries) might

attempt to “link” future trade policies to capital account regimes in much the same manner as they now link them to intellectual property ones. As always in these matters, and other things being equal, the interests of smaller and less developed countries are more likely to be protected in fully multilateral arrangements than in discriminatory ones.

Global Macroeconomic Management

80 Implicit in the increased sensitivity to international interest rates of private capital flows to (and from) developing countries, is the need for greater consideration of the fairly immediate consequences for these flows of the macroeconomic policies of the major industrialised countries. Many analysts argue, with the wisdom of hindsight, that the Volcker anti-inflationary “shock” of 1979 was a major contributor to

the international debt crisis of the 1980s. Yet the links between interest rates in the United States (and to a lesser extent, Germany, Japan and other industrial countries) and macroeconomic developments in developing countries are much tighter today, by virtue of the increased integration of their capital markets, than they were then. Those who model the functioning of today’s global economy must take account of these new linkages through the capital account and the increasingly important potential feedback effects from the economic performance of the developing countries to that of the high-income countries. Macroeconomic policy-makers in the major industrial countries, and those who assess or advise them (including the IMF), must recognise, as never before, the potential global economic consequences of their policy choices.