

Private Capital Flows and Development

The Role of National and International Policies

Professor Gerry K Helleiner



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COMMONWEALTH SECRETARIAT

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Foreword

This paper by Professor G. Helleiner was presented to the Commonwealth Finance Ministers at their meeting in Bermuda in September 1996. It contains a rich discussion of recent trends in private capital flows and their impact on economic development with particular focus on problems related to the volatility of capital movements. In analysing these issues, Professor Helleiner brings to the discussion the experiences of a number of East Asian and Latin American countries that have been successful in coping with surges of capital inflows. He reviews their use of a judicious mix of policies that have included exchange rate intervention, monetary sterilisation, fiscal discipline, and a careful use of direct and price based controls on short-term capital flows. The paper also examines the case for capital account liberalisation and the necessary conditions that should prevail before countries embark on full liberalisation.

Professor Helleiner also examines the role of international financial institutions (in particular the IMF and the World Bank) in underpinning the globalisation of capital flows. He emphasises the importance of establishing a workable early warning system; and a credible financing mechanisms that can be deployed quickly and flexibly to assist countries faced with large and sustained capital surges including contagion effects. Professor Helleiner, however, is less enthusiastic about the early amendment of the IMF's Articles of Agreement to promote capital account convertibility for all Fund members. He argues that, notwithstanding the advantages of an opening of the capital account, there would be difficulties in the transition period. He advocates that capital account convertibility must be appropriately sequenced and preceded by policy reforms. He further argues that capital account liberalisation for a great many developing countries has to be seen as a long term process; and that for some countries, which have already liberalised, temporary controls may continue to be an important tool for responding to capital surges which create macroeconomic problems. He concludes that it would therefore, be premature to rush to an amendment of the IMF Articles that commits all members to the achievement of an open capital account. He also suggests that in a globalised world, it is critical that major industrial countries take account of the increased sensitivity to interest rate changes of private capital flows to (or from) developing countries.

Since the paper was written, the issues raised by Professor Helleiner have become even more relevant in the light of the ongoing crises in several East Asian countries. It is my hope that this paper will help to generate debate and assist countries to gain a better understanding of the policy issues involved in managing and coping with private capital flows, both nationally and globally.

Rumman Faruqi
Director
Economic Affairs Division

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.

Introduction

- 1 Debate over the role of private capital flows in international payments and appropriate government policies relating to them is a relatively recent phenomenon in the developing countries. Discussions of policy towards such flows in developing countries centred in the 1950s and 1960s upon the benefits and costs of foreign direct investment and the problems of “capital flight”. With the dramatic expansion of commercial bank lending to the developing countries in the 1970s and the subsequent debt crisis of the 1980s, attention shifted to analysis of sovereign debt, default, emergency lending, and possible “workout” schemes, with particular reference to the respective roles of government, banks and the international financial institutions. The difficulties encountered with financial liberalisation and the “opening” of external capital accounts in the Southern Cone of Latin America in the late 1970s generated a burst of research and discussion of necessary prerequisites or concomitants of a liberalised capital account and related issues of optimal sequencing (e.g. Diaz-Alejandro, 1985; Corbo and DeMelo, 1986; McKinnon, 1991). With the sharp increase in private international portfolio capital flows to developing countries in the 1990s, particularly to countries in Asia and Latin America, interest in the problems and possibilities they create began to accelerate, as did discussion of the appropriate external capital account regime for the recipient countries.
- 2 By the early 1990s several general analytical studies of these questions had already been undertaken (e.g. Williamson, 1991; Akyüz, 1992; Reisen and Fischer, 1993). In the past few years, stimulated by the Mexican crisis of late 1994 and early 1995, there has been an unprecedented degree of interest among policy makers on the problems created for developing countries by large and volatile international flows of private capital, larger for them than ever before, and appropriate policy responses. Both the IMF and the World Bank have directed a great deal of further attention, during this period, to the problem of volatile private capital flows and the management of capital surges (notably in IMF 1995b and 1995d; EDI, 1995; and Corbo and Hernandez, 1996). Not only has the IMF directed increased research attention to capital account issues in recent years but, in 1995, its Executive Board also authorised increased attention to them in its surveillance activities. Of course none of this recent experience or the analysis thereof has altered the prime need for macroeconomic policy to create a sound framework for private domestic savings and investment decisions, which remain at the core of successful long-term development.
- 3 This paper surveys the current debate on the new forms, and roles, of private capital flows to developing countries in the 1990s and appropriate national and international policy responses to the problems and possibilities they create. Section 2 describes the growth of these flows in the 1990s, their role in development and some of their effects in recipient countries. Section 3 addresses the question of alternative capital account policies for developing countries,

including the role of macroeconomic policies, controls and transaction taxes. In Section 4, the possibility of improved international arrangements is considered, including the provision of increased

liquidity, better procedures for orderly debt workouts, and clarified international regimes. Section 5 contains recommendations stemming from the previous analysis.

The Growing Role of Private Capital Flows to Developing Countries in the 1990s

The New Flows

- 4 Private capital flows to developing countries, after slumping in the 1980s, increased dramatically, and to unprecedented levels, in the first half of the 1990s. According to the IMF, net private flows in the 1989+95 period were, on average, about ten times those of the 1983+88 period, whereas net official flows had fallen by more than half (see Table 1). According to the World Bank, between 1990 and 1993, private capital flows to developing countries rose nearly fourfold before stabilizing at about \$160+170 billion in 1994+95 as United States interest rates rose and the Mexican crisis hit (World Bank, 1996, pp. 10-11). These private flows remain, however, highly concentrated. Only about 20 developing countries are today considered creditworthy by international capital markets and banks. Foreign direct investment is almost equally concentrated. In recent years, the African continent has received only 4 per cent of total net private flows¹.
- 5 In the 1990s there was a sharp increase in international portfolio investment, both in debt instruments and in equity, in developing countries. Foreign direct investment also grew very rapidly though at a slower pace. On the other hand, the relative importance of bank lending to developing countries fell drastically. Much higher proportions of external capital were also now directed to private sector borrowers rather than to governments in developing countries. Tables 2 and 3 summarise the overall composition of capital flows to the major developing areas and selected countries in recent years. Private flows have accounted for very substantial percentages of individual recipient countries' GDP in the 1990s (e.g., 6 and 8 per cent in Colombia and Chile, respectively; 11 and 13 per cent in Thailand and Malaysia respectively). Foreign direct investment has been relatively more important in Asia than elsewhere but the relative contribution of portfolio flows has risen nearly everywhere. In some of the sub-Saharan African countries, "private transfers" as a percentage of GDP have reached remarkable levels (e.g., 9 per cent in Tanzania, 5 per cent in Uganda), although knowledge as to what they really are remains sparse.
- 6 These new flows can be partly explained as a once-for-all (permanent) stock adjustment on the part of the world's investment community (notably insurance companies, mutual funds and pension funds) to newly-liberalised international financial markets, both in developing countries and in the industrialised world, and the perception of new profit opportunities in emerging markets, particularly in countries that have achieved sound macroeconomic fundamentals and a receptive environment for foreign capital. Once such stock

1 The issue of broadening capital flows to a wider group of developing countries is discussed further in FMM(96)3.

adjustment has been completed, however, the flows resulting from it can be expected to fall to more “normal” levels (around which they will continue to fluctuate). It would be helpful, in such circumstances, to address the possibilities for smoothing the macroeconomic adjustment in recipient countries to these one-off shifts in global portfolio choices.

- 7 The new private capital inflows to developing countries can also be seen, however, as an ongoing and perfectly normal response on the part of more globally-oriented investors to changing incentive structures – including relative rates of interest, exchange rate expectations, political volatility, etc. Private capital inflows may also be procyclical, increasing in “good” times and falling, even reversing in direction, in “bad” times. If recent international capital flows (into developing countries) are not significantly the product of “one-off” stock adjustment, but reflect normal response to changing incentives, their surge in one direction is likely to be reversible.
- 8 In any case, newly-liberalised international and domestic financial markets certainly create new opportunities for international incentive-responsive private capital flows and short-term volatility in such flows. When large institutional investors alter their overall international portfolio composition only marginally (for them) they can have dramatic consequences for individual national asset markets and exchange rates. Some of the surge towards developing countries’ financial markets in the early 1990s is undoubtedly attributable to the low interest rates in the United States (and other industrialised countries) at that time (Calvo, Leiderman and Reinhart, 1993).
- 9 External circumstances have always been understood to play an important role in

setting the context for national macroeconomic management, particularly in small open economies. Shocks in the external terms of trade have long been recognised as a particular problem for developing countries. Changes in global interest rates, and their effects upon private international capital flows, have now become a further major source of exogenous shocks. “Contagion effects” from financial events elsewhere (e.g., “tequila effects”) are also now an important additional source of exogenous shock. Policy changes – particularly in exchange regimes – in geographically contiguous countries are another potentially significant source of exogenous influence upon domestic macroeconomic management, as shown in some recent African experiences (e.g., Kenya/Uganda, and the CFA franc zone and its neighbours). Realalignments of major currency exchange rates can also profoundly affect developing countries’ real effective exchange rates and hence their prospects for external balance, e.g., the nominal appreciation of the yen against the dollar in the 1990s brought about depreciation of many East Asian currencies vis-à-vis the yen.

Capital Inflows: Development Impacts and Responses

- 10 Capital inflows are important for developing countries because of their role in supplementing savings and financing investment, thereby assisting in long-term development, and/or in shorter-term smoothing of consumption. In addition, foreign direct investment can also be beneficial in a number of other ways including through transfer of technology and expertise, greater access to foreign markets for domestic goods, and enhanced competition within national markets particularly in services. There is now

increasing competition among developing countries to attract foreign direct investment (FDI).

requirements; or via the redeployment of government deposits from the commercial banks to the central bank.

- 11 It has long been recognised, however, that where there are significant domestic microeconomic “distortions”, capital inflows can be immiserising. Prior to and during the debt crisis of the 1980s there was a great deal of discussion as to how the proceeds of external bank lending (mainly to governments) had been used, and whether they had contributed to development. There has always been appropriate concern as to whether the government had its economic policy fundamentals “right”. There is obviously a continuing need to understand how capital inflows are ultimately used, and whether recipients’ national policies may contribute to any “misdirection”.
- 12 Concern with the potentially destabilising macroeconomic consequences of private inflows, even when policies in the recipient country are basically sound, is much more recent. Surges of inflowing private capital create macro-economic problems, above all, through their effects on either the exchange rate or the domestic money supply, together with the risk of their abrupt cessation or capital outflow.
- 13 If the central bank attempts to maintain stability in the exchange rate, private capital inflows will expand the monetary base (as the central bank increases its foreign exchange reserves). To prevent consequent overheating of the domestic economy, and a real appreciation of the currency, the central bank may seek to sterilise the domestic monetary consequences, through open market operations – in government securities or in the interbank market (as in Malaysia) or, more usually, through the issue of its own securities; or through increased reserve
- 14 Tightened domestic monetary policy may, however, involve significant quasi-fiscal losses for the central bank as it pays higher interest rates on its domestic liabilities (including those earned by foreigners) than it earns on its foreign exchange reserves. To the extent that interest rates increase in consequence of such sterilisation policies, they may induce a further fillip to external capital inflows. (Interest rates are presumably lowered through private capital inflows in the first place, however, and inflows will, in any case, cease once a new portfolio equilibrium is reached.)
- 15 Increasing bank reserve requirements may also “redirect capital flows to domestic borrowers through channels other than the domestic banking system – such as through domestic markets for equity and real estate. If this disintermediation is effective, the macroeconomic stabilization problem would remain” (Fernandez-Arias and Montiel, 1996, p.73). Domestic agents may also resort increasingly to offshore borrowing. Clearly the structure of the domestic financial system and, in particular, the interest of foreign investors in other domestic assets and their access to them are important to overall macroeconomic outcomes.
- 16 One obvious additional (or alternative) possible response to surging capital inflows is to tighten the fiscal regime, and this is frequently recommended, particularly to countries previously running large fiscal deficits. But recent experience indicates that many countries experiencing monetary and exchange rate pressures from private capital inflows had already achieved fiscal balance or even surpluses (e.g. Chile, Korea and others). In any case, as a recent IMF

paper argues, "In most countries ... it is difficult to use fiscal policy as a short-run response, and it may also exacerbate the problem of unsustainable inflows if confidence in economic policy grows strongly" (IMF, 1995d, p.5). Thus, macroeconomic policy instruments other than fiscal ones might be needed to respond to short-term capital surges.

17 If the central bank instead allows the value of the domestic currency to appreciate in response to capital inflows, this will have undesirable consequences for the overall incentive structure. The current account of the balance of payments is likely to deteriorate in response to currency appreciation, and the economy will become increasingly vulnerable to a sudden reduction or reversal of the capital inflows. The critical question is whether the capital inflows that are associated with such an increasing current account deficit are likely to be sustainable and, if so, at what level. Countries operating a pure floating exchange rate system (in some African countries, they seem to have had few options) are consequently faced with a major set of problems: appreciating and potentially unstable currencies, rising current account deficits and rising external debt.

18 In the 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. They can easily spark increased volatility in domestic markets for financial assets and real estate. Capital surges have been associated with stock market and property market booms; and outflows with corresponding busts. Where domestic financial markets are thin and/or weakly supervised, even modest inflows of external

private capital can overwhelm both local financial institutions and their regulatory authorities, and create additional macroeconomic management problems. Even in relatively strong financial systems, deposit insurance, whether explicit or implicit, creates a moral hazard that may encourage over-enthusiastic foreign depositing in domestic banks, and over-enthusiastic (and, particularly when there is rapid expansion, inadequately supervised) bank lending to domestic agents.

19 The increased inflow of foreign portfolio capital in the 1990s did not always destabilise national financial markets in the sense of increasing average weekly exchange rate, interest rate, or stock market volatility. But there were frequent episodes of extreme stock market volatility which did appear to be associated with foreign capital flows – e.g. a stock market boom in late 1993 and early January 1994 in Malaysia, followed by rapid decline again in the first half of 1994; and sudden stock market declines in early 1995 in Thailand and Malaysia in response to the Mexican crisis in early 1995, and the Gulf War in the second half of 1990. Similarly, there were at the same time sharp interest rate changes in response to the same external capital surges, and the pressures on policy that they created.

20 Many developing countries maintain various forms of control over external capital account transactions. The ease and speed with which private capital can flow internationally depends partly on the nature of the capital asset or liability, but, no less importantly, on the costs of the flows to private transactors, as influenced by such capital controls – in the form of restrictions, regulations and taxes, both direct and indirect. To an analysis of such policies for the capital account we now turn.

Policies for the Capital Account in Developing Countries

Benefits and Costs of International Financial Integration

- 21 Capital flows internationally with or without governmental controls over the capital account. Increasing numbers of countries have opted for full capital account convertibility and integration with global capital markets. This is a clear policy option for all developing countries today.
- 22 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. By easing or removing constraints on private decision-making, governments permit private agents to make savings and investment decisions on a freer basis. The result should be a less “distorted” decision-making process both within individual liberalising nations and at the global level. Within the relatively capital-scarce developing countries (no less than elsewhere) this can be expected, in the best-case scenario, to include greater international portfolio diversification for their own investors; greater diversification of capital sources on the part of their public and private borrowers; greater competition and thereby increased efficiency for their financial services sectors; deeper financial markets and the increased efficiency of intermediation that it brings; and greater domestic savings and investment. These potential advantages are great enough to motivate open capital accounts in the OECD and to inspire most countries to declare capital account liberalisation to be an ultimate objective, whatever their current practices. But none of these potential gains are assured, and capital account liberalisation also involves risks and potential costs.
- 23 Firstly, capital account liberalisation would mean that domestic monetary authorities would have less room to pursue monetary policies independently of international interest rates.
- 24 Secondly, liberalisation of capital outflows would mean that domestic savings would no longer be available solely for the purpose of domestic investment. An older literature has long argued that the potential vulnerability of developing countries’ external payments positions or exchange rates to volatile private expectations should make capital account outflows the very last to be liberalised (e.g. Williamson, 1991).
- 25 Thirdly, there is by now plenty of evidence that developing countries can encounter severe macroeconomic management problems, even financial crises, as a consequence of surges of private capital flow which are presumably more likely to occur when capital flows are “freer”. According to much current wisdom, it is critically important for development that countries maintain a stable and appropriate real exchange rate, and thus a stable and sustainable current account, as well as a reasonably stable macro economy. Such stability is seen by many as more important for the achievement of an adequate level

and efficiency of investment than the details of incentive structures which purport to have micro-economic efficiency benefits. For this purpose, it may be desirable to moderate overall capital flows that are not driven by long-term economic fundamentals, and thus attempt to influence the composition, as well as the overall size, of capital flows so as to achieve more stable and more productive inflows. In the face of the limits to the efficacy, in terms of macroeconomic management objectives, of the available fiscal, monetary and exchange rate policy instruments, the monetary authorities of many developing countries have sought to deploy direct and indirect controls over private international capital flows as additional macroeconomic policy instruments. Such capital controls typically seek to alter the pace or composition of private capital flows. Further measures to restrain expansion of consumer expenditures which might otherwise be associated with capital inflows (and, in many cases, with import liberalisation) may also be considered appropriate, e.g., limits upon domestic consumer and mortgage credit, or compulsory private savings programmes (McKinnon and Pill, 1995). These may be able to reduce the prospect of credit-driven booms in private consumption of the recent Mexican type².

26 Fourthly, increased openness in the capital account may involve domestic banks and other financial institutions in increased risks, both because of increased deposit volatility and because of increased foreign exchange risk. Capital account liberalisation therefore is likely to require

prior strengthening of prudential supervision and information disclosure.

27 Capital account convertibility is obviously not a matter of all or nothing. Some types of transactions may be free while others are not; and the tightness of restrictions may vary in the same country over time. In this respect, as in trade policy and the analysis of the current account, "openness" can have a variety of interpretations. There is as yet no agreed way of measuring the degree of openness in the capital account (Montiel, 1994)³. For the present, there seems little alternative but to rely on descriptive accounts, such as the IMF offers in its Annual Reports on Exchange Restrictions, for data on the extent of capital account convertibility and changes therein.

28 Direct regulation of international capital flows, both inward and outward, has evidently been common in developing countries. A summary of existing capital controls in 155 developing countries, based on IMF data, is shown in Table 4. 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. (For further discussion of the IMF Articles, see Section 4(c).) 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. Table 4 shows that regulation of outward flows has been considerably more frequent than that of inward flows. Regulation of

2 Mexican private savings fell from 15.5 per cent to 7.7 per cent of GDP in the 1989+93 period (Schadler *et al.*, 1993).

3 There is no agreed method in the current or trade accounts either but there is a much more extensive empirical literature on the subject, including an important (and remarkably under-cited) one that finds little correlation among alternative such measures (Pritchett, 1991). There seems to be some consensus on the use of the percentage premium on the black market as against the principal official exchange rate as a measure (at least in an ordinal sense) of the strength of overall foreign exchange controls or official currency misalignment.

outward flows also has a longer history and remains fairly pervasive. Restrictions on residents' external investments and holdings of foreign currencies are frequent, at least in the form of upper limits, often based purely on prudential objectives, on the proportion of total assets that financial institutions may place abroad. Of inward flows, FDI is much more frequently regulated than purely financial flows. But there is evidently increasing interest in and resort to controls over the latter. In general, positive lists (in which only those transactions listed are "free") are more restrictive than negative lists (in which only those activities listed are restricted, regulated or prohibited).

detailed composition of such capital flows. Informed analysts conjecture that much of what is at present recorded as private "transfer" in some African countries is actually more appropriately categorised as private capital flow, quite probably quickly reflected in real investment (Kasekende, Kitabire and Martin, 1996). If the authorities do not know which flows are which, they will obviously face great difficulties in developing appropriate policies. Indeed, in some developing country circumstances, authorities are said to be inhibited in their attempts to collect more accurate information on private capital flows by their fear of frightening market participants, discouraging real investors and stimulating undesired outflows (ibid.).

Influencing the Composition of Inflows

- 29 There seems to be general agreement that some forms of external private capital inflow are more attractive to the recipient country than others. From the standpoint of future macroeconomic stability, longer-term and more stable inflows of capital are better. This would suggest a preference for longer-term investments – in long-term loans, equity and/or in the form of FDI⁴, particularly that which takes the form of physical flows of capital goods. Such flows are more likely to be based on long-term economic fundamentals and should be less susceptible to short-term volatility. (Some "reliable" development assistance may also carry these desirable attributes.)
- 30 Categorisation of portfolio capital flows, however, is often difficult. In some sub-Saharan African countries, for instance, the authorities have little idea about the

Short-Term versus Long-Term Flows

- 31 Short-term capital inflows (and outflows) have been an important element in the recent experience of many developing countries (including Thailand, Malaysia and several sub-Saharan African countries, where such flows have dominated). These include:
- ❖ short-term external borrowing (lending) by domestic commercial banks or other local firms;
 - ❖ increased (decreased) non-resident holdings of domestic currency deposits in local banks;
 - ❖ sales (purchases) of short-term money market instruments to (by) non-residents;
 - ❖ reduced (increased) resident holdings of foreign currency deposits (where these are allowed); and

4 There may be significant differences within items which are categorised similarly. Under the heading of long-term loans, for instance, East Asian borrowers averaged bond maturities of nearly 12 years in 1995 whereas Latin American borrowers averaged only 3 years; and Latin American spreads over comparable government benchmark bonds were nearly three times as high as East Asia's (World Bank, 1996, p.11)

- ❖ swap transactions – sales (purchases) of foreign currency simultaneously unwound by forward market contracts.
- 32 Some of these flows may be directly related to real international trade in goods and services. A high proportion, however, may be unrelated to any real transactions, whether international or domestic. If so, they may be highly volatile. In Zambia in the late 1980s, for instance, there were sharp reversals in the direction of such flows involving year-on-year changes amounting to 6-8 per cent of GNP (Kasekende *et al.*, 1996).
- 33 Unfortunately, it is often difficult to distinguish flows that are related to real transactions from purely financial ones, or short-term from long-term flows. Korea has consciously tried to treat capital account transactions related to real investments differently from (more liberally than) purely financial transactions but this is inherently very difficult. Over many years, it has proven difficult even to distinguish current from capital transactions.
- 34 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. Longer maturity instruments are thus not necessarily less volatile in their short-term behaviour than nominally short-term ones (Claessens *et al.*, 1995). According to the IMF, “financial asset flows have become increasingly fungible ... [making it] more difficult for ... countries ... to maintain the effectiveness of their controls” (IMF, 1995d, p. 18). Indeed OECD and EU codes on capital flows have abandoned efforts to distinguish short-term capital flows from others and this indicates that others may eventually be forced along the same route (IMF, 1995d, p. 9). Monetary authorities in Chile, among other 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 (LeFort and Budnevich, 1996).
- ### *FDI versus Portfolio Capital*
- 35 FDI is generally believed to be motivated differently, to behave differently, and to create different macroeconomic (and developmental) effects from portfolio capital flows. Foreign direct investors are presumed to base their decisions on longer-term economic and political fundamentals and thus to be less volatile in their short-term behaviour. FDI also often takes the form of real flows of capital equipment and brings technology and/or managerial and marketing skills along with capital.
- 36 FDI flows can also be volatile. Transnational corporations (TNCs) manage liquid funds as well as flows of real goods and services, and they usually do so very effectively. Foreign direct investors can also, when appropriate, borrow from foreign or domestic financial institutions in pursuit of their international financial flow objectives. FDI can therefore be associated with higher, rather than lower, variability in capital flow, reflecting TNCs’ capacities for managing international intra-firm financial transactions to respond quickly to changing national circumstances (Dooley *et al.*, 1995).
- 37 The regimes for FDI in developing countries are usually quite different from those for portfolio capital, and they are not typically primarily motivated by short-term macroeconomic management considerations. In many ways, FDI inflows are treated more liberally than foreign

portfolio capital because of the recognised advantages brought by its longer-term motivation, and the potential managerial, technological and export market-opening attributes associated with it. On the other hand, there are often selective prohibitions, controls and approval procedures – designed to protect strategic sectors or to ensure national benefits of various kinds – that are more stringent for FDI than for “arms-length” portfolio capital (IMF, 1995d). Although controls over inward foreign direct investment are not usually primarily directed at reducing the volatility of capital flows, they can be. Chile has instituted “minimum stay” regulations for direct investors to complement its reserve requirements for portfolio investors, in pursuit of its macroeconomic stabilisation objectives.

Debt versus Equity

38 External portfolio investment in domestic equities clearly involves fewer risks to the borrowing country than debt. External debt requires servicing regardless of domestic economic circumstances and the rollover of its principal can never be assured. Foreign owners of equity can, of course, choose to exit at any time, but when they do so as a group they must first find domestic buyers and, when they do so, they may be forced to take capital losses that ease the blow to the capital-losing country. There is therefore a risk management rationale for developing countries to favour portfolio equity inflows over debt-creating ones (although they may, on average, be more expensive). It can be argued that the shift towards equity borrowing in the 1990s has already imparted an important stabilising influence on developing country borrowers, relative to their variable-interest bank borrowing in the 1970s (Williamson, 1996b).

Efficacy of Controls

- 39 According to a number of analysts, direct controls (and, for that matter, sterilisation) can only be effective in the short-run: “... given the worldwide integration of financial markets and the sophistication of financial intermediaries, such policies do not seem to work in the long run”. (Corbo and Hernandez, 1996, p. 84).
- 40 It is well-known that controls over capital outflows are difficult to enforce and that considerable capital flight will occur, when market participants deem it warranted, even in the tightest of control regimes – via misinvoicing of trade transactions, leads and lags in external payments, alterations in trade credit terms, etc. The effects of expectations, as always, can also generate unexpected results. The tightening of controls may constitute a signal to investors, generating greater net outflows than before; similarly, liberalisation of outflows may trigger more inflows.
- 41 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 actual social benefits of such controls warrant their administrative and other (including efficiency) costs; and, more fundamentally, whether domestic macroeconomic management is, or is about to become, sound.
- 42 Controls over capital outflows are not universally associated, as some seem to imply, with payments crises or preludes to currency devaluation and payments liberalisation. Many developing countries have maintained such controls over outflows over very long periods of time, and varied them in response to their external payments positions (e.g. IMF, 1995d, p. 21).

43 Controls over capital inflows are generally easier to implement than those over outflows. Dooley's recent survey (1995) of the academic literature on capital controls (which has mainly been addressed to attempts at control of unwanted outflows) concludes that they have often successfully driven wedges between domestic and international interest rates, thereby generating government revenue and reducing the costs of public domestic debt servicing (pp.29-32); but in developing countries, contrary to the evidence for developed countries, they have not succeeded in influencing the volume or composition of capital flows, or exchange rate levels (pp.34-35). This study is also sceptical, in view of the distortions they create, of their overall benefit+cost ratio. (See also Mathieson and Rojas-Suarez, 1993.)

44 However, other analyses of recent developing country experience suggest more optimistic conclusions regarding the efficacy (to be distinguished from efficiency) of capital controls, particularly those relating to inflows (LeFort and Budnevich, 1996; Park and Song, 1996). Many developing country macroeconomic managers evidently believe it is possible to influence not only the pace but also the composition of external private capital inflows.

Recent Policy Response to Capital Surges

45 As has been seen, many developing countries have encountered large surges of capital inflow in the 1990s, which have significantly complicated the tasks of macroeconomic management. In sub-Saharan African countries such as Tanzania, Uganda and Zambia, macroeconomic policy response has consisted primarily in letting the exchange rate reflect the increased capital flows; and this has not yielded results

with which policy-makers can be fully content. In East Asian countries like Indonesia, Korea, Malaysia and Thailand, on the other hand, strenuous efforts were made by macro-economic policy-makers to preserve incentives for their tradable goods sectors by preventing too much real currency appreciation. Inevitably this involved the use of activist policies in currency and financial markets, and pragmatic resort to direct and indirect capital controls that varied in their intensity in response to changing external circumstances. In Chile and Colombia, too, policy-makers sought to moderate the exchange rate effects of the new capital inflows by "managing" exchange rates, monetary sterilisation and judicious resort to capital controls, principally in the form of indirect taxes (via reserve requirements).

46 Recent experience suggests that the vigorous use of market-friendly policy instruments – particularly official participation in financial markets – has helped many developing countries in their pursuit of traditional macroeconomic objectives in the context of volatile international flows of private capital. The most important instruments used have been:

- ❖ flexible central bank intervention in the foreign exchange market, with varying limits and "bands", and without overly rigid adherence to nominal exchange rate targets;
- ❖ flexible intervention by the monetary authorities in domestic financial markets and/or provision to them of new financial instruments for purposes of monetary sterilisation;
- ❖ maintenance of fiscal discipline; and
- ❖ use of reserve requirements (deposits in foreign currency in the Central Bank) on

domestic bank deposits of non-residents, domestic foreign currency deposits, and all external borrowing, bond issues or lines of credit. (These deposits have sometimes included a minimum time period, sometimes varied with the maturity, and have typically been designed to discourage shorter-term flows.)

47 The managers of capital surges in East Asia and Latin America have also often combined their more “market-friendly” instruments with selective and temporary direct regulations.

- ❖ Regulation of inward flows of portfolio capital has involved:
- ❖ overall quantitative restrictions or even prohibitions on some types of flows (e.g. some short-term flows in Malaysia in early 1994);
- ❖ regulation or restrictions on borrowing or issuance of securities abroad by residents;
- ❖ restrictions on access by foreigners to domestic stock and financial markets, or limits on foreign ownership shares of domestic corporations (which often vary with the sector of activity); and
- ❖ certain requirements for foreign direct investment, such as minimum length of stay (e.g. in Chile, one year).

48 Governments have often varied their capital account regulations so as to pursue their macroeconomic objectives as external circumstances changed. Korea systematically tightened or eased restrictions on both capital inflows and outflows in response to developments in the current account of its international payments. To counter excessive inflows, some governments have at times eased regulations only on outflows (e.g. Thailand). They have also varied their reserve requirements on foreign borrowing.

49 Many East Asian and Latin American countries thus appeared remarkably successful in responding to surges of private capital inflows in the 1990s through a judicious combination of exchange market intervention (to moderate real currency appreciation), 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.

50 It is always difficult to assess the effects of policy in the absence of clarity as to the relevant counterfactual. Those with faith in the perfectibility of markets may argue that the provision of greater information is always more socially efficient than governmental interventions. Still, government interventions, including direct controls, did frequently seem to be effective in terms of their own declared (and limited) macroeconomic objectives. It is important to recognise that the purpose of controls in the more “successful” cases was generally not to maintain a fundamentally unsustainable exchange rate, but to assist in real exchange rate stabilisation. In some cases, there may also have been a longer-run concern to prevent undue real currency appreciation and its detrimental effects for the tradables sector. The policy objective was always a stable and appropriate overall incentive structure, and thus effective macro-economic management for development.

51 On the other hand, if capital controls are used to support weak macroeconomic policy, they can be distinctly harmful. Nor are they without difficulties or costs. In Dornbusch’s words, however, “while a near-perfect system of managing capital flows would be desirable, something that falls even far short may still do the job much better than doing nothing” (1995).

52 Policy makers should draw pragmatic conclusions from these recent experiences, like those of a recent literature survey of the same subject: "In view of the multiplicity of factors that should in principle influence the response of macroeconomic policies, no single combination of policies is likely to be optimal in all cases". (Fernandez-Arias and Montiel, 1995, p.76).

New Policy Instrument: A Cross-Border Transactions Tax?

53 There are strong theoretical and practical grounds for relying on taxes on international transactions rather than direct controls. Such taxes (often known as a "Tobin tax") are likely to interfere less with the allocative efficiency of the relevant capital markets, and to be administratively no more (and maybe even less) demanding. They overcome the difficult administrative task of distinguishing long-term from short-term flows by leaving market agents to decide what types of flows will be altered. They also have the important side-benefit of raising fiscal revenues (some of which can be used to fund their own administrative costs). Some developing countries have levied taxes on international financial transactions, most notably Brazil from 1994 onwards; and their experience deserves more study. Obstfeld is among those who have argued that: "A coherent case can be made for a Tobin tax in the context of stabilising developing countries, which need to manage exchange rates and have relatively shallow financial markets, and where the cost of failed stabilisation is extremely high" (Obstfeld, 1995, p. 188).

Such taxes have also been advocated for OECD countries (Eichengreen, Tobin and Wyplosz, 1995) and active professional debate continues over the merits and feasibility of a worldwide Tobin tax (e.g. Felix, 1995; Kenen, 1995; Frankel, 1995; Spahn, 1995; ul Haq *et al.*, 1996).

54 Dornbusch argues for a (small) tax, levied by individual countries, which could be varied over time, on all international (cross-border) transactions so as to discourage short-term capital flows and lengthen investor horizons. Such a tax, he argues, is superior to administrative controls in that "a maximum of market choice and discipline is maintained and a minimum of bureaucratic control intrudes" (1995).

55 He suggests that most of the relevant problems of tax evasion could readily be overcome by imposing the tax on all transactions in foreign exchange, whether for trade in goods or services, or for international capital movement. Since the tax applies to all cross-border flows rather than only to financial transactions, and since its object is to moderate instability in cross-border flows and not financial asset markets, the arguments concerning the ineffectiveness of financial transactions taxes, he argues, are irrelevant. There could be some negative effects on international trade but, at the tax rates contemplated, they would be minimal. Rather, he argues, the tax could be a useful transitory device in the context of stabilisation and the opening of the capital account and would serve to smoothen the process of national integration into the world economy.

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.

Recommendations

- 1 Private international capital flows have become such an important and potentially volatile element in developing countries' economies that their macroeconomic policy makers must acquire accurate and timely information as to their size and composition. The IMF should do all in its power to assist member countries with weak data on these flows to improve them.
- 2 The IMF should be encouraged to recognise capital account controls, direct and indirect, as legitimate macroeconomic policy instruments in most developing countries to deal with volatile capital flows. A revision in the IMF Articles of Agreement to require capital account convertibility of all its members would be inappropriate at this time.
- 3 Monetary authorities in the developed countries should actively assist and co-operate with those in developing countries in the collection of data, monitoring of developments, and implementation of controls on international private capital flows.
- 4 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. (This may require amendments to its Articles of Agreement.) Decisions as to the appropriate procedures for activating such lending and the decisions actually to lend should be taken via the fully multi-lateral decisionmaking mechanisms of the IMF.
- 5 The IMF should be provided with significantly expanded resources, particularly through quota increases and SDR issues, to permit it to play a stabilising role in future financial crises in developing countries.
- 6 The World Bank should be encouraged to play an important complementary financial and advisory role in orderly workouts of sovereign debt problems in developing countries. Bank-IMF co-operation could build on the precedent of the current system of policy framework papers in low-income countries.
- 7 The IMF should be encouraged to expand its role, in conjunction with other relevant bodies, in the surveillance of international capital markets. (Again, this could be facilitated by an amendment to its Articles of Agreement.)
- 8 G-10 proposals on orderly debt workouts represent an important start. Efforts should be made to introduce new provisions in future international debt contracts 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.
- 9 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, e.g., those of the IMF, the WTO and other international and regional institutions or agreements.
- 10 The major industrial countries must take account of the increased sensitivity to interest rates of private capital flows to (or from) developing countries, and the potential for significantly increased feedback effects from the developing countries' performance to the global economy.

Table 1 Developing Countries: Capital Flows¹ (Annual average, in billions of US dollars)

	1973-77	1978-82	1983-88	1989-95	1994	1995
Developing Countries						
Net private capital flows ²	10.2	26.0	11.6	114.3	149.0	166.4
Net direct investment	3.6	9.0	12.6	39.8	61.3	71.7
Net portfolio investment	0.2	1.7	4.3	41.5	50.4	37.0
Other net investments	6.4	15.3	-5.2	33.1	37.3	57.8
Net official flows	11.0	25.5	29.5	11.7	2.6	27.3
Change in Reserves ³	-20.2	-21.7	-9.6	-56.8	-57.9	-75.7
Africa						
Net private capital flows ²	4.5	4.3	0.5	4.9	11.9	9.8
Net direct investment	1.0	0.3	1.1	2.1	2.2	2.1
Net portfolio investment	0.1	-0.3	-0.4	-0.3	1.1	0.1
Other net investments	3.4	4.3	-0.1	3.0	8.6	7.6
Net official flows	2.4	7.2	6.6	2.0	1.5	2.8
Change in Reserves ³	-1.4	0.4	-0.4	-2.1	-5.1	-1.4
Asia						
Net private capital flows ²	4.3	13.9	11.2	45.7	75.1	98.2
Net direct investment	1.4	3.0	5.6	24.4	41.9	52.4
Net portfolio investment	0.1	0.2	0.9	10.1	16.0	18.5
Other net investments	2.8	10.7	4.7	11.2	17.1	27.3
Net official flows	4.0	7.4	6.4	7.2	6.0	5.9
Change in Reserves ³	-6.9	-7.0	-18.0	-38.9	-61.6	-50.0
Middle East and Europe						
Net private capital flows ²	-10.3	-21.1	1.9	29.7	11.4	19.0
Net direct investment	-1.3	-0.1	1.2	0.9	-0.5	0.0
Net portfolio investment	0.0	-0.2	5.0	13.6	15.9	8.4
Other net investments	-9.1	-20.8	-4.3	15.2	-4.1	10.5
Net official flows	2.3	6.6	6.6	-2.6	-1.4	-3.8
Change in Reserves ³	-14.2	-17.6	9.5	-1.4	-0.2	-2.6
Western Hemisphere						
Net private capital flows ²	11.7	28.9	-2.0	34.0	50.7	39.5
Net direct investment	2.5	5.8	4.7	12.4	17.7	17.1
Net portfolio investment	0.0	2.0	-1.2	18.1	17.4	10.0
Other net investments	9.2	21.1	-5.6	3.6	15.6	12.3
Net official flows	2.3	4.4	9.8	5.1	-3.5	22.4
Change in Reserves ³	2.2	2.5	-0.7	-11.4	9.0	-21.7

¹ Net capital flows comprise net direct investment, net portfolio investment and other long-and short-term net investment flows, including official and private borrowing.

² Because of data limitations, other net investments may include some official flows.

³ A minus sign indicates an increase.

Source: IMF, 1996.

Table 2 Percentage Composition of External Long-Term Capital Flows to Developing Countries, 1994

	Private		Portfolio Equity Flows	Official	Total	Total Flows as % of GDP
	Net Debt Flows	FDI				
All developing countries	21.1	38.6	16.8	23.4	100	3.9
East Asia	25.4	50.5	14.8	9.4	100	5.6
Indonesia	17.9	23.2	40.4	18.5	100	5.2
Korea	64.4	10.9	33.9	-9.2	100	2.0
Malaysia	14.4	63.2	19.2	3.2	100	9.7
Thailand	87.5	13.9	-11.7	10.3	100	3.2
South Asia	9.0	45.1	46.3	-0.4	100	3.5
Latin America and the Caribbean	30.7	40.7	25.7	2.9	100	3.2
Chile	39.8	43.6	21.1	-4.4	100	7.9
Colombia	38.9	62.6	21.1	-22.5	100	2.2
Europe and Central Asia	19.7	31.2	7.2	41.8	100	2.6
Middle East and North Africa	3.1	35.8	1.0	60.1	100	2.4
Sub-Saharan Africa	4.4	14.8	4.3	76.5	100	5.1
Kenya	-260.4	3.8	0.0	356.6	100	1.5
Zambia	-13.5	12.6	0.0	100.8	100	13.6
Zimbabwe	-45.6	10.3	14.7	120.6	100	6.3

Source: Calculated from World Bank, 1996, pp. 84-85

Table 3 Major Types of Private Capital Inflow, Selected Countries, as per cent of GDP, 1990-94

	FDI	Net Flow of Short-Term Debt	Net Flow of Long-Term Debt ¹	Private Transfers ²	Total Private Flows
Latin America					
Chile (1990-94)	2.4	3.1	1.2	+	7.7
Colombia (1993-94)	3.0	-0.3	3.8	+	6.3
East Asia					
Indonesia (1990-93)	1.2	0.6	4.3	+	6.1
Korea (1991-94)	0.2	0.4	1.8	+	2.4
Malaysia (1991-93)	7.7	4.7	0.4	+	12.8
Thailand (1990-94)	1.7	6.1	2.6	+	10.5
Sub-Saharan Africa (1990-93)					
Kenya	0.3	0.4	0.2	1.9	2.8
South Africa	0.0	0.3	0.0	0.0	0.3
Tanzania	0.3	-0.4	0.0	9.1	9.1
Uganda	0.1	-0.2	0.0	4.7	4.7
Zambia	2.9	-0.9	0.0	-0.3	1.7
Zimbabwe	0.2	0.8	0.8	0.3	2.0

¹ Including net portfolio equity flows, except in Malaysia.

² Shown only for Sub-Saharan African countries.

Sources: Okasekende, Kitabire and Martin, 1996; LeFort and Budnevich, 1996; Park and Song, 1996

Table 4 Capital Controls in Developing Countries

Category	Number of Countries Maintaining Controls
Any form of capital control	119
Comprehensive controls	67
On outflows	67
On inflows	17
Foreign direct investments	107
Of non-residents	84
Of residents	35
Profit repatriation and capital liquidation	34
Taxes on capital transactions	9
Non-resident-controlled enterprises	6
Portfolio investments	61
Of non-residents	30
Of residents	33
Security issuance by non-residents	15
Security issuance abroad by residents	6
Debt-to-equity conversion	2
Financial transactions	78
Of non-residents	41
Of residents	66
Trade-related financial transactions	7
Deposit requirements for borrowing	
from abroad by residents	2
Deposit accounts	83
Of non-residents in foreign exchange	37
Of non-residents in local currency	52
Of residents abroad	29
Of residents in foreign currency with domestic banks	23
Other capital transfers	70
Personal capital transfers	34
Blocked accounts	24
Real estate transactions	
Of non-residents	23
Of residents	30

Source: IMF, 1995d, p. 35

Table 5 Developing Countries that have Accepted IMF Article VIII Obligations*

Argentina	Jamaica	Panama
Bangladesh	Jordan	Papua New Guinea
Bolivia	Kenya	Paraguay
Chile	Korea	Peru
Costa Rica	Kyrgyz Republic	Poland
Croatia	Latvia	Saudi Arabia
Dominican Republic	Lebanon	Singapore
Ecuador	Lithuania	South Africa
El Salvador	Malaysia	Sri Lanka
Estonia	Mauritius	Thailand
The Gambia	Mexico	Trinidad & Tobago
Ghana	Moldovia	Tunisia
Guatemala	Morocco	Turkey
Haiti	Nepal	Uganda
Honduras	Nicaragua	Uruguay
India	Oman	Venezuela
Indonesia	Pakistan	Zimbabwe

* *Low and middle-income countries with populations of one million or more.*
Source: IMF, Annual Report on Exchange Restrictions, 1995

Table 6 Commonwealth Countries that have Accepted IMF Article VIII Obligations

Antigua & Barbuda	India	Seychelles
Australia	Jamaica	Sierra Leone
The Bahamas	Kenya	Singapore
Bangladesh	Kiribati	Solomon Islands
Barbados	Malawi	South Africa
Belize	Malaysia	Sri Lanka
Botswana	Malta	Swaziland
Canada	Mauritius	Tonga
Cyprus	New Zealand	Trinidad & Tobago
Dominica	Pakistan	Uganda
The Gambia	Papua New Guinea	United Kingdom
Ghana	St. Kitts & Nevis	Vanuatu
Grenada	St. Lucia	Western Samoa
Guyana	St. Vincent & the Grenadines	Zimbabwe

Source: IMF, Annual Report on Exchange Restrictions, 1995 and IMF bulletins

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Annex

A Note on Insolvency and Sovereign Debt Workouts¹

- 1 The issue of insolvency and sovereign debt workout has been addressed in the G-10's May 1996 report, entitled "The Resolution of Sovereign Liquidity Crises". In the case of a sovereign borrower it is difficult to define insolvency, in contrast with the case of a firm. A firm's net worth is, in principle, well defined. A sovereign debtor in financial distress also owns a collection of assets and liabilities. One of the main assets of a state, however, is the capacity to tax. There is no fixed limit to this capacity, so there is no fixed point beyond which a mismatch between assets and liabilities constitutes insolvency. Nevertheless there comes a point beyond which reasonable analysis suggests that the state is unable to pay, even if this analysis is to some extent political. It is desirable to have some substitute for a bankruptcy procedure at national levels to cope with this eventuality.
- 2 There are essentially four parts to an efficient bankruptcy procedure, each of which needs some analogue in international sovereign debt workouts:
 - ❖ protection from an economically inefficient initial 'grab race' by creditors, including a stay on interest payments;
 - ❖ the injection of new temporary 'working capital' financing (normally on preferential terms, by providing administrative priority for new creditors);
 - ❖ enterprise restructuring and the appointment of new management; and

❖ balance sheet (debt) write-down.

- 3 In a world of complete information and costless negotiations, there would be no need for recourse to any institutional mechanisms to achieve these desired outcomes. Instead, the parties could write down contractually what to do, or how to bargain, in all circumstances. But in the real world circumstances of international capital markets it is extremely difficult to remove debt overhangs; this is because there are no mechanisms for the restructuring of securitised debt and the number of creditors is large and dispersed.

Workouts and the balance sheet write down

- 4 The G-10's May 1996 Report argues that certain contractual provisions, if broadly incorporated in international debt contracts, could help to facilitate debtholders' decision-making and hence the resolution of a sovereign financial crisis. The proposals that they contemplate involve the following three elements:
 - a **Collective representation:** By providing holders of international securities with effective mechanisms for communicating with other bond holders and with debtors, collective representation could enable them to proceed with debt restructuring more smoothly and quickly. Macmillan (1995)² discusses the required leadership and co-ordination and considers whether there should be one international bondholder council or national bondholder councils. He also considers whether a

¹ This material is based on a draft paper prepared for the Commonwealth Secretariat by Richard Portes and David Vines entitled, "Coping with International Capital Flows". The authors are Director and Senior Fellow, respectively, at the Centre for Economic Policy Research, London.

bondholder council should be a representative organisation. The best structure for such an organisation would depend on who would appoint representatives (government, bondholders or some combination) and on what mandate the representatives would employ. This could produce two quite different models of organisation. One would be a quasi-official permanent representative council having significant political power, which could negotiate with the debtor but only with the power to recommend outcomes, not to bind.

Alternatively the council would help bondholders to appoint their own representatives with rules governing their election to a negotiating committee. As Macmillan argues, funding for such a council would be important since debt crises can be sudden disasters following long periods of stability; organising funding for an institution with sporadic expenditure needs will be difficult.

- b **Qualified majority voting clauses:** Such clauses will enable changes to be made in the terms of a bond contract without the unanimous consent of the holders. This would limit the scope for a small minority of creditors to stall or block the workout process. Eichengreen and Portes (1995)³ suggest that debt instruments should be appropriately modified to authorise a (qualified) majority of bondholders to reschedule debt issues, as in the case of corporate debt. Market participants argue that this may undercut the creditors' rights too severely. Others note that the London Club steering committees for the rescheduling of commercial bank debt have, in effect, routinely 'imposed' terms on other banks – after lengthy negotiations, the few remaining dissidents have a take-it-or-leave-it (or go to court) choice. Even when they have ini-

tiated legal action, the settlements have proceeded.

- c **Sharing and similar clauses:** As an addition to (or alternative to) qualified majority voting clauses, sharing clauses could be used as a mechanism to raise the threshold for disruptive bondholder behaviour, as well as oblige debtors to treat creditors in a fair and equitable manner. However, there is little experience with the effects of such clauses when the number of creditors is large and dispersed, as in the case of bonds. Thus, in addition, it could be required that all legal proceedings be consolidated, and that there be a minimum proportional requirement (e.g. 25 per cent) of bondholders needed before a lawsuit was allowed.
- 5 These proposals go further than those of the G-10. But Portes and Vines argue that they need to go further still in one more important way. Real progress will require that the official sector press the markets to adopt at least the reforms recommended by the G-10 report, rather than expect 'market-led' reforms.

Crisis resolution: the creditor stay, financing and 'new management'

- 6 As in the case of domestic financial distress, there is a need for a creditor stay, for financing and for 'new management'.

Creditor Stay

- 7 It is necessary to prevent the 'creditor grab' race which occurs in cases of prospective default. In the sovereign debtor case, the race involves capital outflow. Is it possible to institutionalise mechanisms for dealing with

2 Macmillan, R. (1995), 'Towards a sovereign debt workout system', *Northwestern Journal of International Business Law*, 16:1, 57-106.

3 Eichengreen, B., and R. Portes (1995), *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, Centre for Economic Policy Research (CEPR), London.

financial distress without the reimposition of capital controls? If not, and if one of the central aspects of liberalisation is the removal of such controls, what then? Might not the mere possibility of debt workout negotiations make the likelihood of capital outflow all the greater?

- 8 A debtor government can in effect impose a stay, simply by stopping payments. If it does so under force majeure, non-confrontationally, and with at least tacit IMF approval, creditors are unlikely to penalise it. The G-10 report suggests that the IMF could signal its approval by lending into arrears, and this seems a sensible proposal. The report says such cases should be “rare ...[and] conditioned on very strong adjustment efforts on the part of the debtor country and limited to cases where the debtor country is making reasonable efforts to negotiate with its creditors”. This is a realistic approach, provided that the criteria are as stated: the ‘rare’ cases should not be limited to large countries with political and economic clout.

Financing

- 9 The new IMF Emerging Financing Facility, to be created by increasing the General Agreements to Borrow, is also relevant here. Although it is intended primarily to deal with short-term liquidity crises, it is also necessary in the case of an overall package which, without financing, might come unstuck due to liquidity problems. If there are to be more negotiations to deal with the longer run issues of debt reduction and restructuring, then there will be more need for liquidity finance to carry debtors over. This is an additional argument for lending into arrears and, hence, for expansion of the resources available to the Fund, i.e. for a substantial quota increase.

‘New Management’

- 10 In corporate bankruptcy, part of the penalty to the management which lessens the risk of moral hazard is the sanction of changing the management. Clearly, this is ruled out for sovereign governments. But the possibility of linking financing with agreement on an IMF-supported adjustment programme provides a safeguard against the moral hazard problem.

A Realistic Way Forward

- 11 The G-10 sees the adoption of clauses providing for bondholder representation, qualified majority voting, and sharing as a ‘market-driven process’. Governments are to recommend such provisions and hope that the markets will respond on their own. It is, however, unrealistic to assume that this will happen. If such changes were so desirable and so easily adopted, the markets would have done so already. There would be no need to recommend action. In fact, there exist significant obstacles to market-driven reform (Eichengreen and Portes, 1996⁴).
- 12 The G-10’s proposals, if adopted, would be a positive step. But they must also be supported by parallel initiatives to enlarge IMF quotas, and endorsement by the IMF’s Executive Board of the G-10 proposals regarding lending into arrears.
- 13 Institutional reform to cope better with future crises will therefore require strong leadership from its supporters and an effective campaign to win over the financial community. Otherwise the next Mexico-type crisis – with no official bailout – could run the risk of seriously undermining the stability of global financial markets and the ability of an increasing number of developing countries to gain further access to these markets.

4 Eichengreen, B., and R. Portes (1996), ‘Managing the next Mexico’, forthcoming in symposium edited by P. Kenen for International Finance Section, Princeton.

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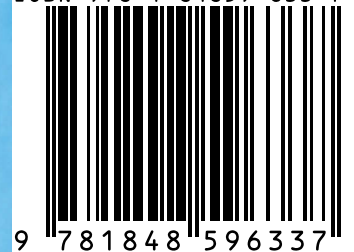
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