

Contemporary Issues in the International Relations of the Developing World
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Developing Countries and the International Financial Architecture
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The 1990s have been marked by a series of crises that pose a serious challenge to the international financial and monetary system. Developing economies are particularly vulnerable. Four main problems have been identified: the costs of short-term capital flight, the risks of contagion, the asymmetry of intervention and issues related to exchange rate regimes. As a result, reforms are being explored in five areas: information and disclosure, capital controls, investor incentives, international investment standards and the roles of IFIs. Clear answers have yet to emerge but both private investors and developing countries will need to be more involved in the design of effective reforms.

The problem

International financial crises have been a recurrent theme in the 1990s. The list is long: the ERM crisis of 1992-93; the Mexican peso devaluation, or the Tequila crisis, of 1994-95; East Asia in 1997; Russia in 1998; Brazil in 1999. Irrespective of their immediate causes, the crises demonstrated four problems of the world economy that afflict particularly the developing countries.

- The Perils of Short-term Capital Flows For example, capital inflows to East Asia of US \$75.6 billion in 1996 turned into outflows of US \$52.2 billion in 1998 (IIF data). Few economies, however stable, could sustain such a swing. In contrast, interestingly, the movement of direct equity flows remained constant or increased at the same time.
- The Perils of Contagion Financial crises have tended to spread to neighbouring economies, almost without regard to their macroeconomic policies.
- The Problem of Intervention Intervention has often been asymmetric, casting the most burden on the debtors and bailing out investors.
- The Problem of Exchange Rates The crises have increased doubts that a floating exchange rate policy contributes to the stability of the international monetary system.

Five areas for reform

In response, reform has been suggested in five policy areas.

1. Data dissemination

Many believe that the crises were a product of missing information. As a result, there is a new emphasis on the importance of publishing updated accounts by borrowing governments and international organisations. Availability of information, it is argued, would enable investors to make better decisions about loans, and would also improve transparency and policy-making in borrowing governments. This has had a positive

effect on developing economies, by increasing transparency and democracy in their economic policy-making. However, the information that would have been required to avert the crises, pertains to short-term flows. The aggregation and instantaneous publication of such data is difficult and expensive even for developed countries, let alone developing ones. Further, developing country governments have been the main targets for promoting data collection and dissemination. This asymmetric focus effectively reduces the burden on the private sector which, in reality, shares much of the responsibility for capital flight.

2. Exchange rate regimes and capital controls

The old orthodoxy advocated a fixed exchange rate as an effective protection against inflation. However, the new orthodoxy, espoused by the IFIs, has replaced fixed exchange rates with more flexible regimes, often fully floating exchange rates. The dangers of short-term capital flight have now thrown the new orthodoxy into question. Alternatives yield no obvious answers. A purely floating system may facilitate monetary policy independence and greater flexibility in response to shocks. But small open economies often lack the institutions required for the maintenance of a floating regime. Currency boards permit little monetary policy flexibility. Further, fixed rates expose the currency to speculative attacks, as was experienced by Argentina in 1999. Argentina has considered the possibility of 'dollarisation'. US officials, however, have stated explicitly that they will not extend bank supervision to a 'dollarising' country. Difficulties in charting an exchange rate policy have led to two different policy goals. One alternative might be to have target zones for major currencies that which would dampen the volatility faced by developing countries, or at least make regime choice easier. Another possibility would be to have temporary capital controls, such as the Chilean example of taxes on short-term capital flows. However, such controls are difficult to administer and lose their effectiveness over time.

3. The nature of intervention and the involvement of the private sector

Public intervention has often bailed out the private investors and created incentives for them to make poor decisions. This 'moral hazard' effect might be corrected by greater involvement of creditors in crisis management. Various means have been suggested: 'voluntary' involvement or possibly new rules for IMF lending that would impose formulae for 'bail-ins'. The redistribution of losses between creditors and debtors would work to the advantage of debtor developing countries by reducing the costs of adjustment. However, any alteration of lending rules might increase the costs of loans, while compulsory 'bailing-in' might precipitate even quicker capital flight. These changes might work differently for countries that are too small to pose a systemic risk, such as Pakistan and Ecuador, which have renegotiated their bonds with the approval of international institutions and much agonising in the private sector. Renegotiations for the larger developing countries will be less easy.

4. Setting standards

Financial crises are likely to recur as long as there is unevenness in regulation and institutions among different economies. As a result, the international financial

architecture debate places great stress on standards that extend beyond data dissemination into areas such as competition policy, ethics, accounting and banking regulation and supervision. However, most developing countries interpret 'global standards' to mean 'US standards'. Even if there were agreement on what these 'global standards' might be and who would monitor and enforce them, economic and legal rules in one country would not necessarily work in another. This is especially so when the standards encroach into deep social and cultural norms in national economies. It is unlikely that global standards will be agreed quickly or make a great contribution to international financial stability.

5. Reform of the International Financial Institutions:

The recent crises demonstrated that the IMF (and other institutions working in related issue areas) are under-resourced and under-powered to deal with the challenges of the 1990s. Hence there has been considerable focus on increasing the Fund's resources and on making it an international lender of last resort. However, besides the logistical problem of limited resources due to lack of political will, the new role envisaged for the IMF would increase the moral hazard problem.

International institutions have two policy options available to increase their effectiveness. The first one is that of coercion and heavier conditionality. However, heavier conditionalities would reduce the willingness of countries to turn to the Fund, and also result in the abandonment of reform programmes as soon as possible. A heavier conditionality model would also have to be accompanied by an increase in resources. However, the political will to provide such an increase in resources is absent among developed countries. The second, more viable option is that the IFIs can try to promote greater participation of developing countries, and thereby create 'ownership' of the policy process. Developing countries would have to be given a place at the negotiating table, where they are able to help shape solutions in accordance with their needs and evolving expertise.

A huge limitation of the financial architecture debate is that it has been played out in the G-22, the G-X and then in the Financial Stability Forum. As a result, it has not considered the views of the majority of developing countries. Only the 'systemically important' developing countries have been included in any discussions. As a result, any solutions proposed are unlikely to have a lasting effect, as they require the commitment and participation of developing countries for their implementation. This is especially so as many of the solutions involve reform of practices that fall within domestic legislation.

Discussion

In the course of the discussion, Chairperson Louise Fawcett raised the question of the reaction of developing countries to the proposals outlined so far. The speaker pointed out that developing countries have been included only at different points in the debate and have very different interests. But even the 'systemically important' developing economies, included in the discussions, have realised that they lack bargaining power, especially when consulted in the absence of smaller states.

In response to another question about why it was not enough to include only the systemically important developing countries in the debate, the speaker highlighted how the contagion effect makes it difficult to determine which economies are actually systemically important. The collapse of the baht in Thailand, not seen as a systemically important economy, precipitated the East Asian financial crisis with systemic repercussions.

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