Part II: Regional outlook

Chapter 5

External vulnerability and macroeconomic policy

The volatile capital flows characteristic of the third phase of globalization have brought major instability to economic growth in Latin America and the Caribbean, and the authorities have found it hard to keep the real economy on course in the face of sharp variations in international liquidity. This reflects problems arising from the procyclical macroeconomic management that has become widespread across the region, and also the absence of an international financial architecture capable of correcting the financial-market instability and the glaring asymmetries that exist in financial development and macroeconomic behaviour between developed and developing countries.

This chapter analyses the relation between the new forms of external vulnerability stemming from volatile capital movements, and macroeconomic policy. The first two sections focus on external funding sources available to Latin American and Caribbean countries, and the way fluctuations in such financing have combined with procyclical macroeconomic policies to produce the sharp and pronounced business cycles that were such a feature of the region in the 1990s. Based on these considerations and those discussed in the previous chapter, the two final sections provide a detailed description of a number of items on domestic and international agendas to address this volatility.

I. Composition of external financing and vulnerability

In the 1970s, international credit expansion allowed economies to grow on the back of large balance-of-payments current account deficits and unsustainable structures of expenditure and relative prices; this culminated in the debt crisis (see figure 5.1). In the 1980s, the shift from a net positive resource transfer to a large negative transfer meant a "lost decade" in terms of economic development. Output growth averaging 5.6% per year in the 1970s was followed by severe external, fiscal and financial crises; this led to the adoption of a series of adjustment and stabilization programmes which played a major role in reducing regional GDP growth to 1.2% per year.

In the 1990s, renewed but volatile access to international capital flows gave rise to brief cycles of growth, punctuated by periods of slowdown or outright recession. The net result was unstable and mediocre regional growth averaging 2.9% per year between 1990 and 2001. Although achievements such as fiscal control, lower inflation and enhanced credibility of the macroeconomic authorities are remarkable in themselves, they have failed to generate dynamic and stable economic growth processes in most of the region's countries.

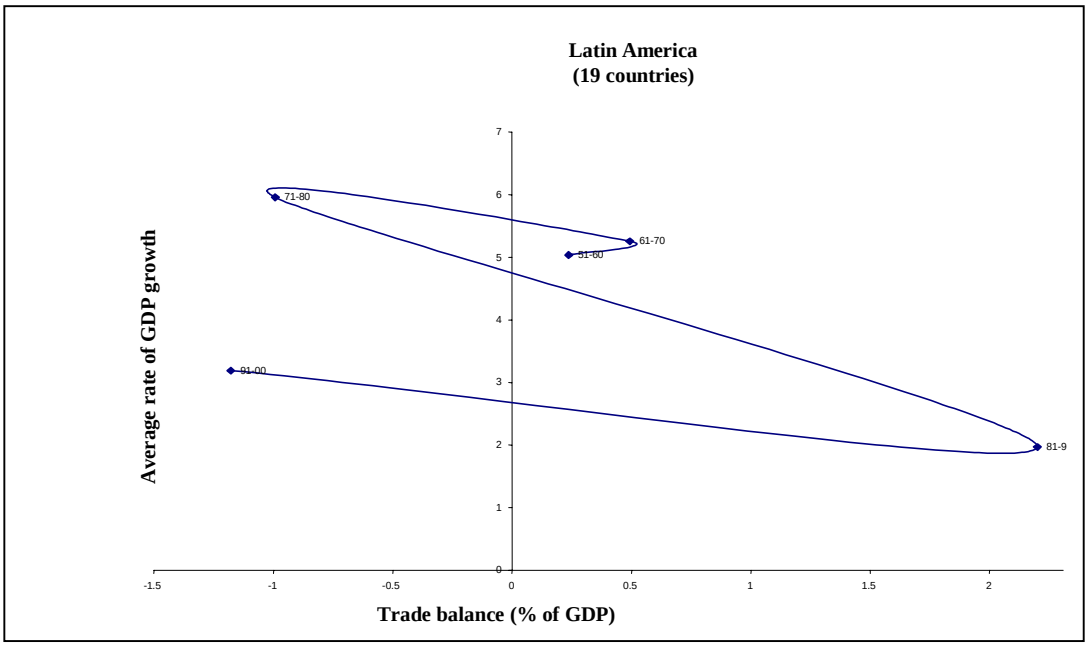
1. Anatomy of capital flows in the 1990s

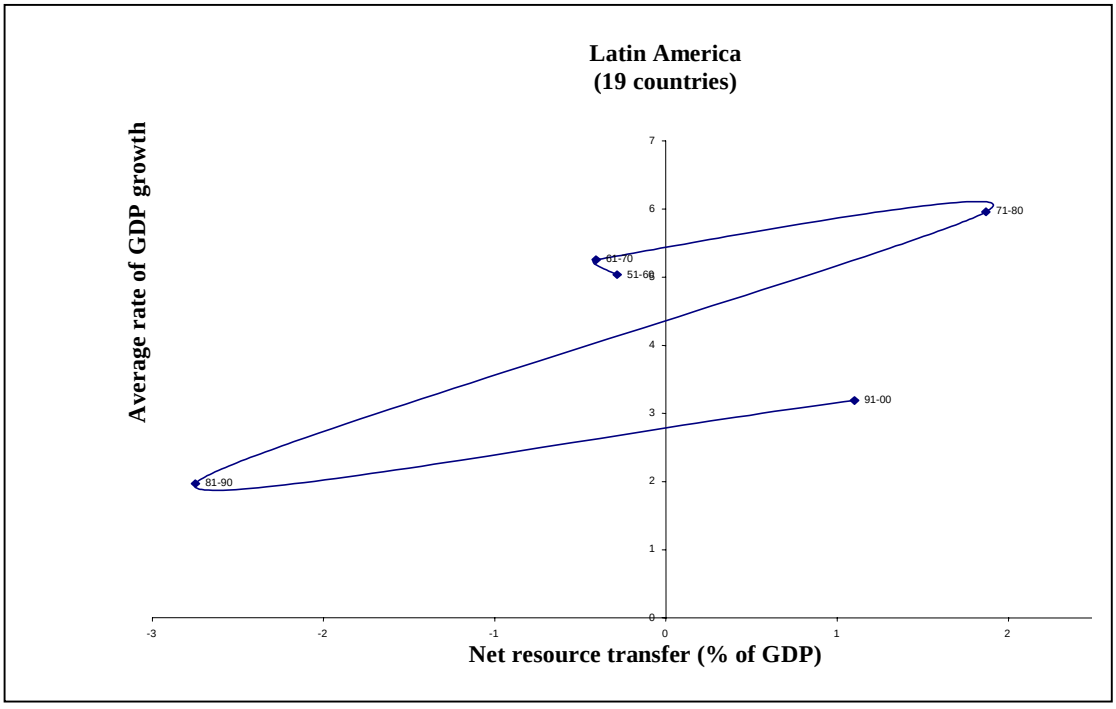
In contrast to the 1970s, when most external financing came in the form of syndicated bank loans, in the 1990s foreign direct investment (FDI) and bond flotations took on this role. FDI trended strongly upwards to account for three quarters of net capital inflows into the region during the decade, interrupted only by the international crisis of 2001-2002 (see table 5.1). Although mergers and acquisitions were important, firstly of privatized firms and later among domestic private-sector enterprises, over half of FDI inflows were used to expand productive capacity.

In clear contrast to FDI, bond issues fluctuated widely, and their financing conditions proved highly sensitive to the vagaries of international markets. The average maturity of new bond flotations varied from three to five years in the first half of the decade, rose to about 15 years in 1997 and then fell sharply to fluctuate between five and eight years in 1998-2001. Financing costs dropped to their lowest level in 1997, but then rose steeply in August 1998 following the Russian moratorium. Since then, they have remained above the levels prevailing until 1997, with a sharp increase in 2001 largely concentrated in Argentina (see figure 5.2).

Like bonds, net inflows from commercial banks were highly volatile and never regained the conditions prevailing before the debt crisis, especially as regards maturities. Equity porfolio flows and American depositary receipt placements (ADRs) have proved to be the most unstable financing sources (see figure 5.2). These two sources of funds and placements jointly fluctuated downwards until 1996-1997, and then fell steadily from 1998 onwards.

Figure 5.1
PATTERNS OF GROWTH, TRADE DEFICIT AND NET RESOURCE TRANSFER





Source: ECLAC, on the basis of official figures.

Table 5.1
LATIN AMERICA AND THE CARIBBEAN: SOURCES OF EXTERNAL FINANCING, 1990-2000
(Net flows in millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 a/
Total (*A+B+C+D*)	**43,887**	**43,793**	**41,255**	**69,120**	**63,117**	**102,056**	**93,076**	**99,969**	**94,881**	**95,173**	**69,151**
A. Debt											
Official b/	6,823	3,435	1,220	2,674	-1,301	9,307	-8,212	-4,447	9,125	2,275	-2,701
Bonds	101	4,133	4,738	20,922	14,306	11,793	29,764	10,562	18,306	19,067	10,965
Commercial banks c/	2,731	1,275	4,302	201	6,212	15,068	16,200	29,646	-7,994	-16,130	4,339
B. Investment											
Direct	6,758	11,066	12,506	10,363	23,706	24,799	39,387	55,580	61,596	77,313	64,814
Portfolio	896	6,938	8,042	27,185	13,160	7,643	13,893	9,947	1,748	3,893	2,305
C. Grants d/	2,350	4,165	2,622	2,908	2,645	3,333	3,181	2,719	3,215	2,949	3,100
D. Compensatory funding e/	24,228	12,781	7,825	4,868	4,389	30,113	-1,136	-4,038	8,885	5,806	-13,671

Source: ECLAC, on the basis of official figures from the World Bank, the International Monetary Fund and the Bank for International Settlements.

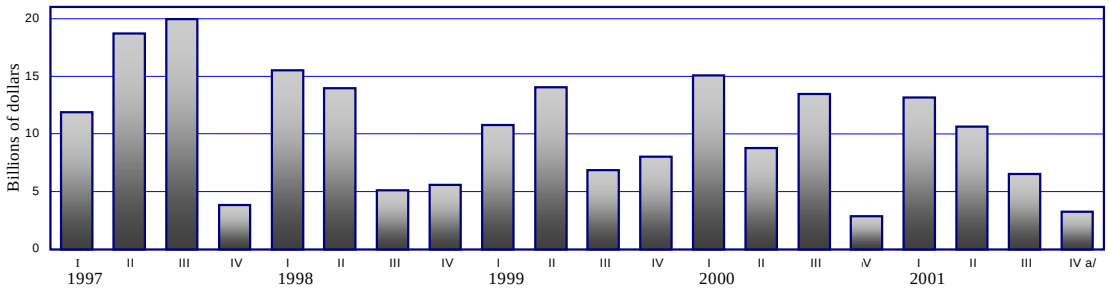
a/ Preliminary estimates.
b/ Includes bilateral and multilateral financing, excluding loans from IMF.
c/ Since 1998 includes short-term flows.
d/ Excludes technical cooperation.
e/ Includes IMF credits and exceptional financing. In the early 1990s, exceptional financing mainly covered interest arrears; in more recent years, however, it has included funds provided by multilateral organizations, apart from IMF and developed-country governments.

In contrast, official and compensatory financing behaved in countercyclical fashion, expanding when private financing dried up in 1995 and again from 1998 onwards. This reflects support provided by the International Monetary Fund (IMF), together with other multilateral financing organizations and a number of developed-country governments in periods that were especially critical for certain countries of the region, particularly Mexico in late 1994, Brazil in 1998-1999 and Argentina in late 2000.

Access to external private financing also tended to be concentrated in the region's relatively larger and more developed economies (see table 5.2). Expressed as a percentage of the respective GDP, total net long-term flows increased in countries with middle and high per capita incomes, but declined in low-income countries. The fall in the latter group was basically the result of a sharp reduction in official financing and grants, only partly compensated by higher FDI (see table 5.3). Despite this unfavourable trend, however, low-income countries received more long-term financing in relation to GDP than middle- and high-income countries: 14% of GDP between 1990 and 1999 in the first case, compared to 5.4% of GDP in middle-income countries and 4.8% in the higher-income countries.

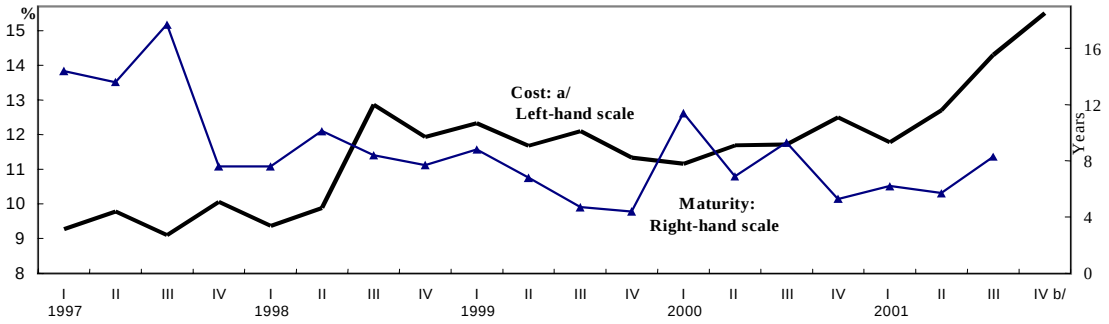
Figure 5.2

a) LATIN AMERICA AND THE CARIBBEAN: INTERNATIONAL BOND ISSUANCE



Source: ECLAC, on the basis of figures provided by the International Monetary Fund, J.P. Morgan and Merrill.
a/ October and November.

b) LATIN AMERICA AND THE CARIBBEAN: CONDITIONS OF INTERNATIONAL BOND ISSUES



Source: ECLAC, on the basis of figures provided by the International Monetary Fund, J.P. Morgan and Merrill.

a/ Sum of average spread on bond placements and the yield on long-term United States treasury bonds.
b/ October and November.

Table 5.2

LATIN AMERICA AND THE CARIBBEAN: NET PRIVATE RESOURCE FLOWS, 1990-1999

(Annual averages, in millions of dollars and percentages)

	Foreign direct investment		Portfolio capital flow		Total private investment		Memo (1999): Percentage	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	GDP a/	Population
Latin America and the Caribbean	**32,937**	**100**	**9,214**	**100**	**42,151**	**100**	**100**	**100**
Low-income countries b/	1,845	5.6	8	0.1	1,853	4.4	5	14.4
Middle-income countries c/	3,844	11.7	902	9.8	4,746	11.3	10	15.4
High-income countries d/	27,248	82.7	8,304	90.1	35,552	84.3	85	70.2
Argentina	5,442	16.5	1,132	12.3	6,575	15.6	16	7.4
Brazil	9,909	30.1	2,785	30.2	12,694	30.1	30	34.2
Chile	1,937	5.9	288	3.1	2,226	5.3	4	3.0
Mexico	8,179	24.8	3,750	40.7	11,929	28.3	27	19.7
Venezuela	1,676	5.1	311	3.4	1,986	4.7	6	4.8
Others	105	0.3	37	0.4	142	0.3	2	1.0
	Bonds		**Loans from commercial and other banks**		**Total private debt**		**Memo (1999): Percentage**	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	GDP a/	Population
Latin America and the Caribbean	**13,647**	**100**	**10,691**	**100**	**24,337**	**100**	**100**	**100**
Low-income countries b/	**10**	**0.1**	**97**	**0.9**	**107**	**0.4**	**5.1**	**14.4**
Middle-income countries c/	**914**	**6.7**	**1,100**	**10.3**	**2,014**	**8.3**	**9.8**	**15.4**
High-income countries d/	**12,723**	**93.2**	**9,494**	**88.8**	**22,217**	**91.3**	**85.1**	**70.2**
Argentina	4,871	35.7	578	5.4	5,448	22.4	16.2	7.4
Brazil	2,594	19.0	4,808	45.0	7,403	30.4	30.2	34.2
Chile	528	3.9	1,538	14.4	2,066	8.5	3.9	3.0
Mexico	4,202	30.8	2,317	21.7	6,519	26.8	27.4	19.7
Venezuela	353	2.6	-14	-0.1	340	1.4	5.9	4.8
Others	174	1.3	267	2.5	441	1.8	1.6	1.0

Source: ECLAC, on the basis of official figures provided by the World Bank, *Global Development Finance 2001*, Washington, D.C., 2001, and national sources.

a/ Calculated on the basis of values expressed at current prices.

b/ The low per capita income group of countries consists of Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua and Paraguay.

c/ The middle per capita income group of countries consists of Colombia, Costa Rica, Jamaica, Panama and Peru.

d/ The high per capita income group of countries consists of Argentina, Barbados, Brazil, Chile, Mexico, Trinidad and Tobago, Uruguay and Venezuela.

Table 5.3
LATIN AMERICA AND THE CARIBBEAN: LONG-TERM EXTERNAL FINANCING BY GROUPS OF COUNTRIES, 1990-1999
(Percentages of GDP)

Groups of countries (simple averages)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Mean	Std. Dev.
I. Net long-term flows												
Low per capita income countries a/	15.2	22.9	15.6	11.2	12.4	11.3	11.8	14.5	12.6	12.9	14.0	3.5
Middle per capita income countries b/	3.2	4.6	2.3	4.6	5.2	4.2	5.7	9.0	8.4	6.5	5.4	2.1
High per capita income countries c/	1.9	2.3	2.6	3.8	5.0	4.0	7.1	7.3	7.4	6.7	4.8	2.2
II. Official financing d/												
Low per capita income countries	8.6	4.4	3.9	2.5	2.8	2.3	2.2	4.3	1.8	2.5	3.5	2.0
Middle per capita income countries	0.3	1.0	-1.3	-0.4	-1.0	-0.6	-1.2	-0.4	0.0	0.0	-0.4	0.7
High per capita income countries	1.0	0.5	0.4	0.2	0.1	0.2	-0.3	-0.1	0.5	0.0	0.3	0.4
III. Financing in bond markets												
Low per capita income countries	0.0	0.0	0.0	0.4	0.1	0.0	-0.1	-0.1	-0.1	0.1	0.0	0.2
Middle per capita income countries	-0.1	0.0	0.0	0.2	0.5	0.3	0.8	1.7	1.9	1.3	0.6	0.7
High per capita income countries	-0.4	0.1	0.6	1.1	0.8	0.8	1.7	0.4	1.1	1.1	0.7	0.6
IV. Financing through other private sources e/												
Low per capita income countries	-0.4	-0.9	-1.4	-0.3	-0.4	-0.7	0.5	0.5	0.4	0.6	-0.2	0.7
Middle per capita income countries	-0.6	-0.7	-0.1	0.2	0.1	0.3	0.1	1.0	0.1	1.2	0.1	0.6
High per capita income countries	0.0	-0.3	-0.4	-0.7	0.3	0.2	0.3	0.8	1.4	-0.2	0.1	0.6
V. Foreign direct investment f/												
Low per capita income countries	0.8	0.9	6.7	3.3	3.7	3.5	3.3	4.5	5.9	6.3	3.9	2.0
Middle per capita income countries	2.0	1.9	2.4	2.2	4.0	3.0	4.5	6.1	6.0	3.7	3.6	1.6
High per capita income countries	1.1	1.7	1.5	2.0	3.1	2.6	3.2	5.3	4.3	5.7	3.0	1.6
VI. Portfolio investment												
Low per capita income countries	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Middle per capita income countries	0.0	0.0	0.3	0.8	0.8	0.7	1.1	0.3	0.1	0.1	0.4	0.4
High per capita income countries	0.2	0.3	0.4	1.0	0.6	0.3	2.2	0.9	0.1	0.1	0.6	0.6
VII. Grants												
Low per capita income countries	6.2	18.4	6.3	5.2	6.2	6.1	5.9	5.4	4.7	3.4	6.8	4.2
Middle per capita income countries	1.6	2.4	1.1	1.7	0.7	0.5	0.4	0.3	0.4	0.2	0.9	0.7
High per capita income countries	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1

Source: World Bank, *Global Development Finance 2001*, Washington, D.C., 2001.

a/ The low-income group consists of countries which in 1998 had a per capita GDP of less than US$ 2,000, estimated at the market exchange rate, namely Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua and Paraguay.
b/ The middle-income group of countries consists of Colombia, Costa Rica, Jamaica, Panama and Peru.
c/ The high-income group of countries consists of Barbados, Brazil, Chile, Mexico, Trinidad and Tobago, Uruguay and Venezuela.
d/ Official financing consists of loans from bilateral and multilateral sources.
e/ Includes loans from commercial banks and other private lenders.
f/ Figures refer to FDI inflows, without deducting investment abroad by the reporting economy.

2. External financing and the business cycle

Although the fluctuations the region's economies have experienced over the past decade have varied in type, the most outstanding feature has been the key role that external financing flows have begun to play in determining the business cycle (see box 5.1 and figure 5.3). Although the trade cycle and movements in the international terms of trade continue to play an important role, exposure to volatility and contagion associated with new forms of external financing has become the main source of external vulnerability among the region's economies. The sovereign-bond risk premium, which reflects financial agents' perception of a country's capacity to meet its obligations, has also become one of the most important macroeconomic prices.

Box 5.1
THREE CRISES IN LESS THAN A DECADE

The present crisis in Latin America and the Caribbean is the third time in less than a decade in which regional GDP growth had fallen off steeply and dragged per capita GDP down along with it. The two previous crises occurred in 1995 and in 1998-1999. Because all of these crises have been the result of external shocks, attention is being focused on the channels through which these shocks are transmitted. Their impact is then, of course, reflected on the balance-of-payments trade and capital accounts.

Viewed from this perspective, the three crises have differed from one another in some very significant ways. The differences have to do with these crises' varying degrees of globality, which influences the relative importance of transmission mechanisms in each. This, in turn, has implications for the consequent economic policy responses.

The 1995 crisis was not a global crisis. It originated in a single country (Mexico) and was therefore transmitted through financial rather than trade channels. The devaluation of the Mexican peso in December 1994 triggered capital outflows from various countries and the virtual suspension of voluntary external financing but, ultimately, the only country other than Mexico to be seriously affected was Argentina, which then pulled Uruguay down with it. Trade did, however, provide an adjustment mechanism for this crisis within an international environment marked by significant growth and massive financial assistance for Mexico and Argentina. As a result, the crisis only lasted for three quarters.

The crisis that broke out in Asia in the second half of 1997 falls into the mid-range in terms of its origin and scope. The contagion effect transmitted through trade channels was considerable, but financial channels played the greatest role in allowing it to spread. The trade-based effects chiefly took the form of declining prices for a number of the raw materials of importance to the region, such as petroleum, other minerals and some agricultural products. The financial turbulence that arose in Asia was heightened by the Russian Federation's moratorium and currency devaluation in August 1998. This led to a deepening of the crisis in 1999, which left a trail of financial instability in its wake that is still in evidence today. On the other hand, the United States economy's high growth rate had positive trade effects on Mexico and Central America, and the impacts of the crisis were consequently concentrated in the South American countries.

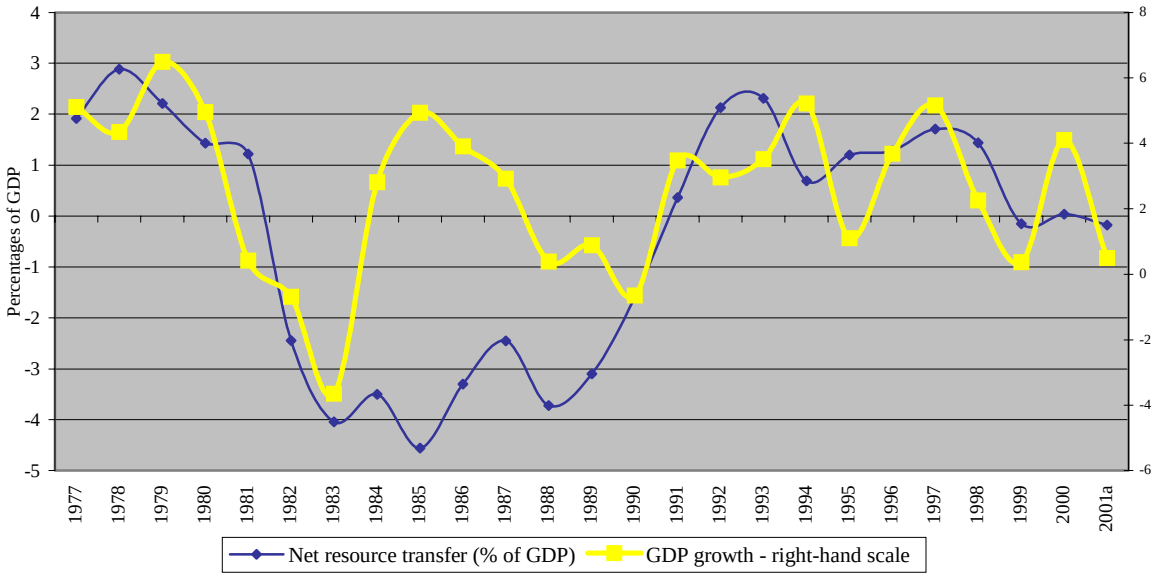
Unlike its predecessors, the current crisis —triggered by a severe slowdown in the world economy that began in a country that has an overarching influence on global and regional economic activity— is truly global in nature. Trade has therefore been the principal channel for the transmission of this crisis, which has been manifested in slower growth or a contraction of export volumes and in a downturn in raw materials prices that has hurt a majority of the countries.

The primarily financial transmission of the first two crises —and the fact that, at the time, the countries were in the midst of stabilization programmes involving the use of exchange-rate anchors— took away much of the economic authorities' manoeuvring room. As external financing tightened, it became necessary to cool down demand by means of what amounted to a procyclical economic policy response. Because of the global nature of the present crisis, measures taken by the countries to boost external competitiveness and galvanize domestic demand, no matter how desirable and necessary they may be, will not be enough to achieve these ends. All these factors point up the need to supplement national policies with international and regional

Fuente: ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 2001* (LC/G.2153-P), Santiago, Chile, 2001. United Nations publication, Sales No. E.01.II.G.182.

Figure 5.3
PROCYCLICAL MOVEMENTS IN ECONOMIC ACTIVITY AND NET RESOURCE TRANSFER

Latin America and the Caribbean: net resource transfer and rate of growth of GDP
(Percentages of GDP and percentage)



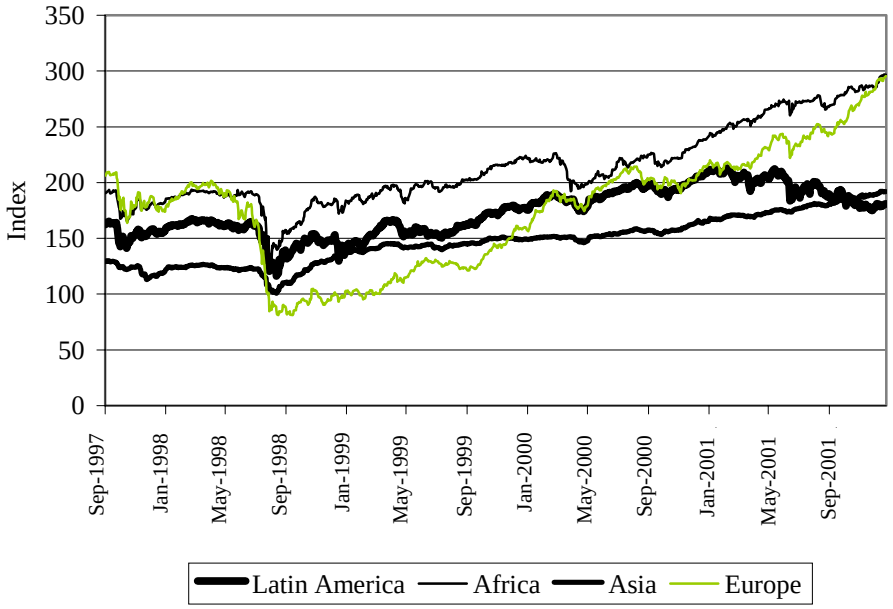
Source: ECLAC, on the basis of official figures.

Parallel sovereign-risk trends among different countries, relatively independent of the soundness of their macroeconomic fundamentals, is a clear illustration of the contagion that has characterized private capital markets, both in times of expansion (contagion of optimism) and in periods of crisis (contagion of pessimism). This phenomenon was especially pronounced during the 1996-1997 upswing and during the Asian and Russian crises (see figure 5.4). Markets have also tended to develop in parallel more recently, but contagion from the Argentine crisis of 2001 was much less marked. In fact it only affected a few South American countries (Brazil and Chile in particular), and even these broke free from Argentine market trends in the final quarter of 2001.

The lessons that emerge from an analysis of the crises endured by a number of countries in the second half of the 1990s (Mexico in 1994-1995; Indonesia, Korea and Thailand in 1997; Russia in 1998; Brazil in 1998-1999; and Argentina in 2001-2002, among others) suggest that the vulnerability of economies to sudden changes on international financial markets is essentially caused by three factors: (i) the size of the deficit on the current account of the balance of payments; (ii) reliance on highly volatile financing flows, especially short-term credit lines and portfolio flows; and (iii) the soundness of domestic financial systems, especially their capacity to withstand interest- rate and exchange-rate fluctuations.

Figure 5.4

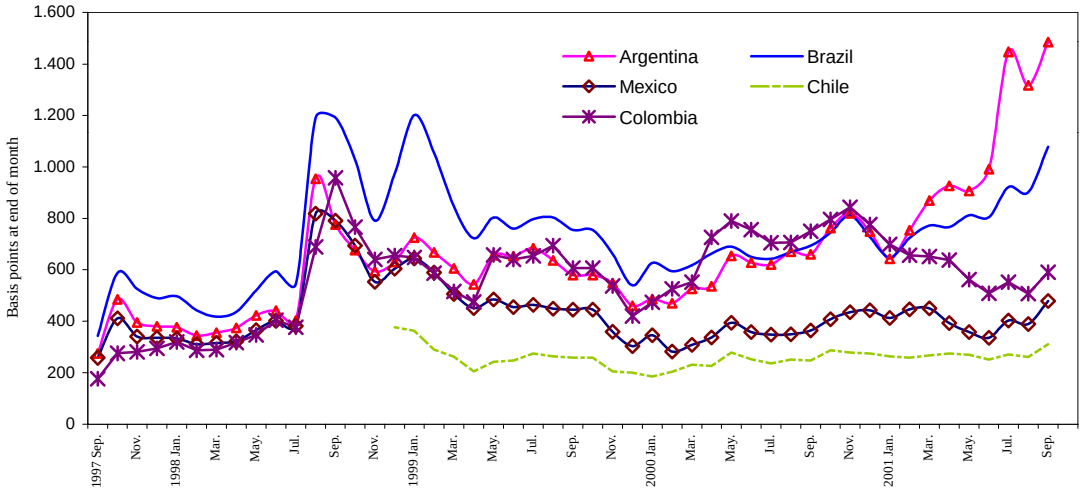
a) TREND OF GLOBAL EMERGING MARKETS BOND INDEX (EMBI)



Source: J.P. Morgan.

b) EUROBOND SPREADS

(With respect to yields on United States Treasury bonds)



Source: J.P. Morgan, *Emerging Markets Bond Index Monitor*.

Against this backdrop, the relation between short-term liquidity requirements (represented by the relative size of short-term debt and other liquid liabilities) and the backing that countries receive to meet such liabilities (represented by available international reserves) have come to be seen as important indicators of external vulnerability (Rodrik and Velasco, 1999). Consequently, lowering the ratio of short-term external debt to international reserves has become an increasingly common macroeconomic policy objective, on which major progress has been made in many of the region's countries since the Asian crisis (see table 5.4). Stronger prudential regulation and oversight of domestic financial systems has also been a major goal, but progress here remains inadequate in several countries, as indicated below.

Table 5.4
LATIN AMERICA AND THE CARIBBEAN: TREND OF BALANCE OF PAYMENTS, 1990-2001
(Annual averages as a percentage of GDP)

	1990-2000	1990-1994	1995-1997	1998-2000	2001a/
Current account balance					
Latin America	**-2.6**	**-2.2**	**-2.6**	**-3.4**	**-2.8**
Low-income countries b/	-8.2	-9.4	-7.5	-6.9	-8.2
Middle-income countries c/	-4.2	-2.9	-4.9	-5.6	-3.6
High-income countries d/	-1.4	-1.1	-1.0	-2.1	-1.6
Trade balance					
Latin America	**-0.9**	**-0.4**	**-1.0**	**-1.6**	**-1.2**
Low-income countries	-10.3	-8.7	-10.4	-12.9	-14.4
Middle-income countries	-2.0	-1.2	-3.3	-2.0	-1.3
High-income countries	0.7	1.2	1.0	-0.3	0.3
Balance on capital and financial accounts e/					
Latin America	**2.9**	**2.5**	**3.3**	**3.2**	**1.7**
Low-income countries	4.4	2.2	6.4	6.1	6.5
Middle-income countries	3.7	1.8	5.9	4.5	0.7
High-income countries	2.4	2.4	2.5	2.3	0.2

Source: ECLAC, on the basis of official figures.

a/ Preliminary figures.
b/ The low-income group consists of countries which in 1998 had a per capita GDP of less than US$ 2,000, estimated at the market exchange rate, namely Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua and Paraguay.
c/ The middle-income group consists of countries which in 1997 had a per capita GDP of between US$ 2,000 and US$ 4,000, namely Colombia, Costa Rica, Jamaica, Panama and Peru.
d/ The high-income group consists of countries which in 1997 had a per capita GDP of more than US$ 4,000, namely Argentina, Barbados, Brazil, Chile, Mexico, Trinidad and Tobago, Uruguay and Venezuela.
e/ Includes errors and omissions.

In the 1990s, the average balance-of-payments current account deficit amounted to 2.6% of GDP, with the trade gap averaging nearly 1%. Unlike the Asian economies, the region's countries have maintained a persistent current account deficit, even in periods of abrupt slowdown in economic growth. This makes them even more reliant on external financing. Nonetheless, the weightings of the individual factors that combine to make up the current account deficit vary widely from one country to another: whereas the trade deficit is a fundamental factor in low-income countries, debt service has been more important in middle- and high-income countries (see table 5.5).

Table 5.5
INDICATORS OF EXTERNAL VULNERABILITY AMONG DEVELOPING COUNTRIES, 1990-2000
(Percentages)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000a/
Developing countries											
Short-term external debt/ Total external debt	16.8	17.2	18.4	18.5	18.3	19.8	20.7	20.1	15.9	15.8	15.9
Short-term external debt/ International reserves	109.0	96.9	102.6	89.2	83.6	79.1	73.7	71.1	57.9	56.5	51.0
External debt service/Exports	18.1	17.2	16.3	16.2	15.9	15.7	16.4	17.1	18.2	21.4	17.0
Total interest/Exports	7.8	7.7	6.7	6.4	6.3	6.6	6.3	6.2	6.9	6.7	6.0
Total external debt/ Gross national product	30.9	32.7	34.3	36.4	38.2	38.3	36.1	36.1	42.9	40.6	37.4
International reserves/Imports (months)	2.9	3.2	3.1	3.6	3.8	3.9	4.2	4.1	4.7	4.7	4.3
Current account balance/ Gross national product	-0.5	-1.6	-1.8	-2.7	-1.8	-2.0	-1.8	-1.6	-1.0	0.0	0.9
East Asia and the Pacific											
Short-term external debt/ Total external debt	17.9	19.2	20.9	22.0	24.7	28.6	31.5	28.1	18.2	16.8	17.0
Short-term external debt/ International reserves	57.0	54.8	72.2	69.7	70.2	78.1	77.3	76.1	41.9	33.6	30.9
External debt service/Exports	15.7	13.4	13.5	14.1	12.1	11.4	12.1	11.2	12.9	15.8	10.8
Total interest/Exports	6.0	5.9	5.0	4.8	4.5	4.7	4.6	4.6	5.1	4.6	4.0
Total external debt/ Gross national product	29.8	30.2	30.6	31.5	32.0	31.0	30.8	33.7	41.6	36.4	32.6
International reserves/ Imports (months)	4.0	4.3	3.5	3.7	4.1	3.9	4.4	4.3	6.4	6.4	5.2
Current account balance/ Gross national product	-0.6	-1.3	-0.9	-2.2	-1.2	-2.3	-2.5	0.4	6.0	4.3	2.9
Latin America and the Caribbean											
Short-term external debt/ Total external debt	16.3	17.6	18.5	20.2	20.1	20.0	18.5	19.1	16.0	14.8	15.6
Short-term external debt/ International reserves	131.8	116.4	97.5	93.7	103.2	93.6	75.7	77.7	76.6	79.0	82.4
External debt service/Exports	24.4	24.1	26.1	27.7	25.3	26.4	31.3	35.6	32.5	41.6	35.7
Total interest/Exports	12.2	12.7	11.3	11.0	11.1	12.2	11.7	11.2	11.9	13.0	11.8
Total external debt/ Gross national product	44.6	43.6	40.9	40.3	37.9	39.9	38.0	36.6	41.1	41.8	38.5
International reserves/Imports (months)	3.6	4.2	4.8	5.2	4.4	4.8	5.2	4.7	4.2	4.0	3.5
Current account balance/ Gross domestic product	-0.2	-1.5	-2.7	-3.3	-3.3	-2.2	-2.1	-3.3	-4.5	-3.2	-2.4

Source: World Bank, *Global Development Finance 2001*, Washington, D.C., 2001.

a/ Preliminary figures.

II. Globalization and real macroeconomic instability

1. Procyclical behaviour linked to the financial accelerator

The close relation between the business cycle and the net resource transfer is determined from abroad by a series of mechanisms operating through domestic financial systems and exchange-rate policy. In periods of abundant capital inflow, economies tend to err on the side of excessive domestic credit and liquidity expansion; in recessions precisely the opposite happens, resulting in an exaggerated liquidity contraction. These powerful financial amplifiers tend to accentuate booms and also intensify the severity of recessions. Moreover, using exchange-rate policy as a nominal anchor, at times of abundant external funding, has resulted in sharply lower inflation rates, but at the cost of increasing appreciation of the real exchange rate. When external capital flows subsequently dry up, this appreciation turns into the Achilles heel of stabilization policy, in many cases giving rise to painful adjustment processes.

When net external capital inflows turned sharply positive in the late 1980s and early 1990s, domestic credit expanded from 22% of GDP in 1988 to 30% in 1993, while stock market indices soared by over three and half times and local currencies appreciated considerably (see figure 5.5). The Mexican crisis of December 1994 brought these phenomena to an halt. A resumption of abundant inflows of international capital in 1996-1997 triggered a new cycle of domestic financial expansion, involving soaring share prices and real appreciation, which was interrupted by the Asian crisis of 1997 and particularly the Russian crisis of 1998. The "wealth effects" generated in upswing periods proved later to be unsustainable. In fact, real appreciations were not reversed during the crises in all countries, particularly those that maintained fixed or semi-fixed exchange-rate regimes.

The instability of private capital flows undermined the capacity of the real economy to react to crisis situations, as trade-protection and export-promotion policies lost importance and the exchange rate became the main determinant of competitiveness. Currency appreciation during expansionary phases, which discourages technological development and the conquest of markets, resulted in losses of productive capacity and marketing networks which, as indicated in studies on "Dutch disease",[1] have proved persistent in many cases.

Several of the region's governments have been forced to intervene in their domestic financial systems during crisis periods, assuming the "lender of last resort" function of the central bank. This entails the public sector assuming some of the risks incurred by private agents that overborrowed in the upswing phase, and invariably leads to large fiscal or quasi-fiscal losses (IMF, 1998, chap. IV; ECLAC, 2001a, chap. 1). One of the paradoxes of this situation is that fiscal balance during upswing periods may conceal contingent fiscal liabilities, in the form of "implicit insurance" for private-sector debts, whose magnitude is unknown initially and only becomes evident when crisis breaks.[2]

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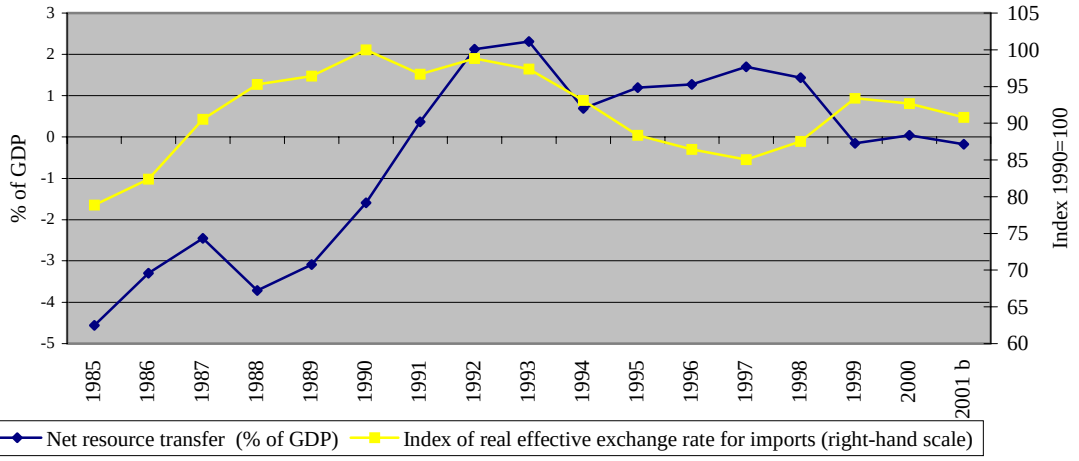
[1] This is one of the key conclusions of the literature on "Dutch disease" in its dynamic versions. See, in particular, Krugman (1990b chap. 7) and van Wijnbergen (1984).

[2] This situation developed in the 1990s as a result of the risks governments assumed by providing guarantees for private investments in public infrastructure. As such investments are more likely to be made during expansionary periods, but the guarantees take effect during crises (minimum revenue or profitability guarantees, in particular), they acquire a procyclical nature. This is an untransparent practice in the absence of explicit estimates of the fiscal risks involved (ECLAC, 1998d).

Figure 5.5
NET RESOURCE TRANSFER AND APPRECIATION OF CURRENCY AND FINANCIAL ASSETS

a) Latin America and the Caribbean: net resource transfer and index of real efective exchange a/

(Percentage of GDP and indices, 1990=100)



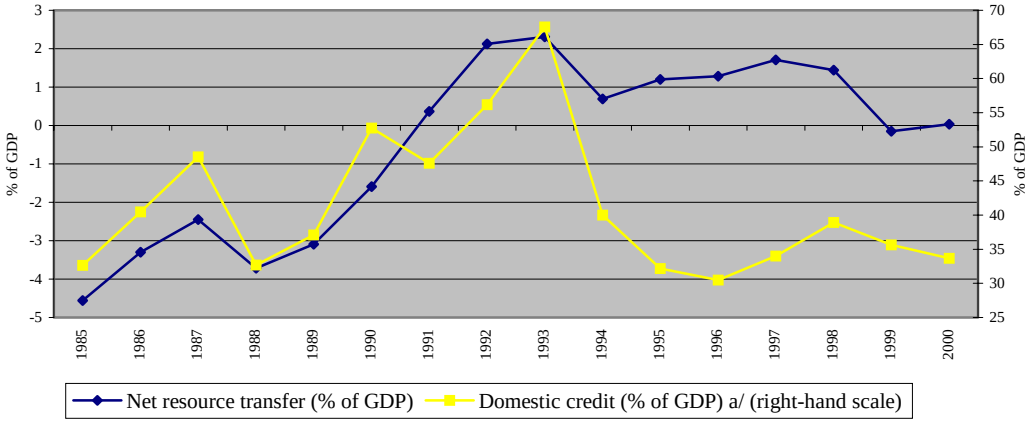
Source: ECLAC, on the basis of figures provided by the International Monetary Fund (IMF) and national bodies and ECLAC, *Postwar Transfer of Resources Abroad by Latin America*, Cuadernos de la CEPAL series, No. 67 (LC/G.1657-P), Santiago, Chile, July 1992. United Nations publication, Sales No. E.91.II.G.9.

a/ The net resource transfer is equivalent to net capital inflows (including non-autonomous flows, and errors and omissions), minus the balance on the income account (profits and net interest payments). For the real effective exchange rate for imports, the median value for Latin America was used; this corresponds to the average of indices of the (official main) real exchange rate of each country's currency against those of its main trading partners, weighted by the relative share of imports to those countries. The weightings correspond to the average for the period 1994-1998.

b/ Preliminary figures.

b) Latin America and the Caribbean: net resource transfer and domestic credit

(Percentage of GDP)



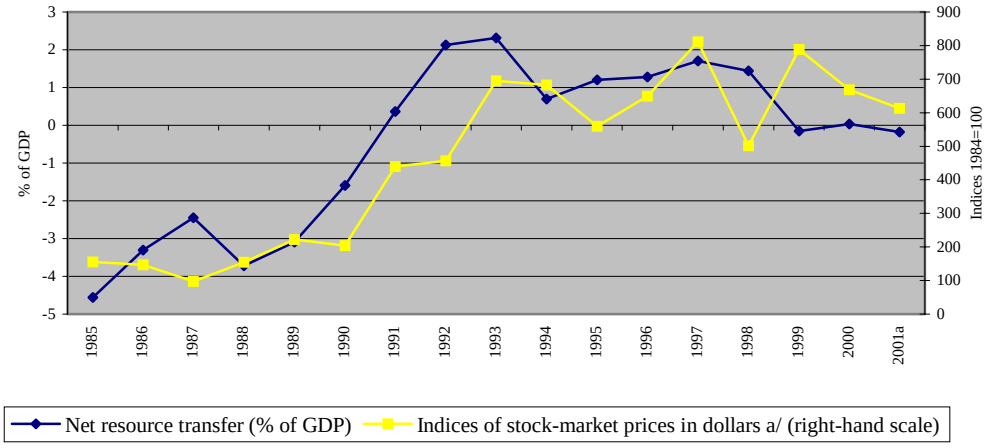
Source: ECLAC, on the basis of figures provided by the International Monetary Fund *(International Financial Statistics)* and national sources.

a/ Figures on domestic credit exclude Brazil for the entire period, and Colombia in 1986 and 1989.

Figure 5.5 (concluded)

c) Latin America and the Caribbean: net resource transfer and strock market price indices in dollars

(Percentage of GDP and indices 1984=100)



Source: ECLAC, on the basis of figures provided by the International Finance Corporation; and ECLAC, *Postwar Transfer of Resources Abroad by Latin America*, Cuadernos de la CEPAL series, No. 67 (LC/G.1657-P), Santiago, Chile, July 1992. United Nations publication, Sales No. E.91.II.G.9.

a/ End-December values of the International Finance Corporation Global Price Index (IFCG) for Latin America. Up to September 2001.

Given the strategic importance of the exchange-rate anchor in price-stabilization programmes, some of the region's countries introduced a variety of forms of asymmetric capital-account control (applying stricter rules on capital inflows than on outflows), in order to avert an excessive appreciation of the exchange rate and calm the volatility of speculative financial capital movements. Besides allowing the central bank to retain a degree of autonomy over monetary policy management, this had a positive effect on the composition of capital flows, as shown by experience in Chile and Colombia (ECLAC, 1998a and 2000a, vol. III, chap. 1).

From the mid-1990s onwards, however, many countries eased capital account regulations, or abandoned them entirely (the last country to do so was Chile, between April and May 2001), moving towards greater exchange-rate flexibility. In fact, the most frequent response to crisis, or the threat of one, was to change the exchange-rate regime. There was a general preference for various types of exchange-rate flexibility albeit with varying degrees of intervention, although clearly there were major regional exceptions to this general rule (see table 5.6). Events in several countries show that adjustments under fixed exchange-rate regimes have been more traumatic in terms of their impact on real economic variables (growth and employment) than when they take place under more flexible regimes.

The trend towards exchange-rate flexibility has gone hand in hand with the spread of monetary policy practices aimed essentially at controlling inflation (inflation targeting). This involves setting annual or multi-year inflation targets, with a view to informing economic agents of the central bank's intentions and making monetary management more transparent. It also allows for more flexible management of monetary instruments in accordance with the trend of inflation and the economic situation in general. Reducing inflation has undoubtedly been the greatest success of stabilization policies over the past decade. Given the high rates of inflation traditionally recorded by several of the region's countries, this is a major achievement. Since the late 1990s, most Latin American and Caribbean countries have managed to keep inflation in single digits.

Table 5.6
LATIN AMERICA AND THE CARIBBEAN: EXCHANGE RATE REGIMES, 2002

Fixed, quasi-fixed or dollarized	**Crawling peg or flotation band**	**Floating** a/
Barbados	Bolivia	Argentina
Belize	Costa Rica	Brazil
Ecuador	Dominican Republic	Chile
El Salvador	Honduras	Colombia
Eastern Caribbean States	Nicaragua	Guatemala
Panama	Uruguay	Guyana
		Haiti
		Jamaica
		Mexico
		Paraguay
		Peru
		Trinidad and Tobago
		Venezuela

Source: ECLAC, *Luces y sombras: América Latina y el Caribe en los noventa*, Santiago, Chile, 2000.

a/ Floating regimes usually involve some degree of central-bank intervention (dirty floating).

2. The procyclical behaviour of public finances

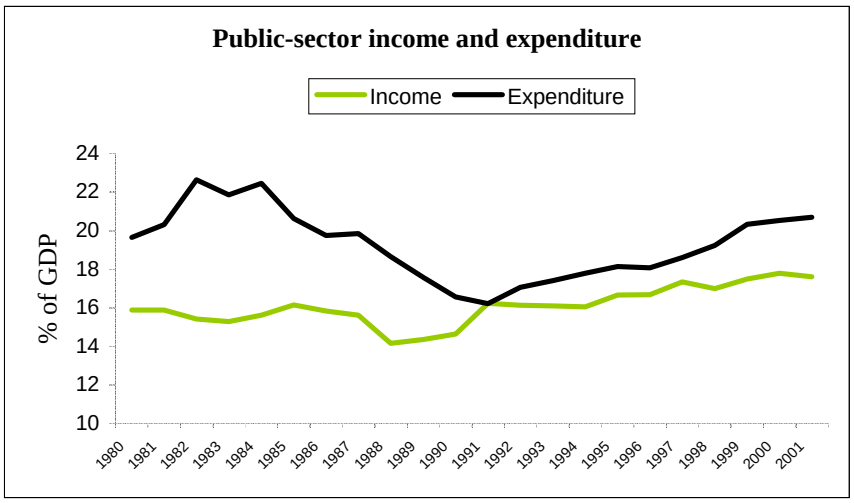
The macroeconomic programmes implemented in the 1990s also gave prime importance to securing gains made during the debt crisis in terms of reducing the fiscal deficit (see figure 5.6). The revival of economic growth and the design of better tax systems enabled fiscal revenues to recover strongly. Between 1990 and 2000, 16 of the region's countries managed to increase central government tax revenue (see figure 5.7). Revenue growth has been particularly notable in VAT, and to a lesser extent among direct taxes. Social security contributions display wide disparities, because several of the region's countries reformed their pension system, which, to a greater or lesser extent, altered the public-private mix of social security financing and coverage.

The recovery of fiscal revenues allowed public expenditure to grow by four percentage points of GDP during the 1990s: from 16.6% of GDP in 1990 to 20.7% in 2001. This also made it possible to restore the level of public-sector social expenditure, which rose from 10.4% of GDP in 1990-1991 to 13.1% in 1998-1999. This latter trend was more pronounced during the first half of the 1990s, after which it began to weaken (ECLAC, 2001c, chap. IV).

In a context of fiscal programming with an annual horizon and public revenues that closely follow the business cycle, targeting the short-term deficit (rather than the structural deficit or level of expenditure) has given rise to procyclical public expenditure policies. An analysis of 31 episodes of variation in the business-cycle-adjusted public-sector deficit[3] shows that fiscal policy behaved procyclically in 25 cases. In 14 of the 16 cases where output growth was above trend, the public-sector deficit was also greater, reflecting expansionary fiscal policy (see figure 5.8). On the other hand, when economies have grown more slowly than the medium-term trend, the public-sector deficit has also been smaller, with a surplus even recorded in 12 of the 16 episodes, reflecting restrictive fiscal policy (Martner, 2000).

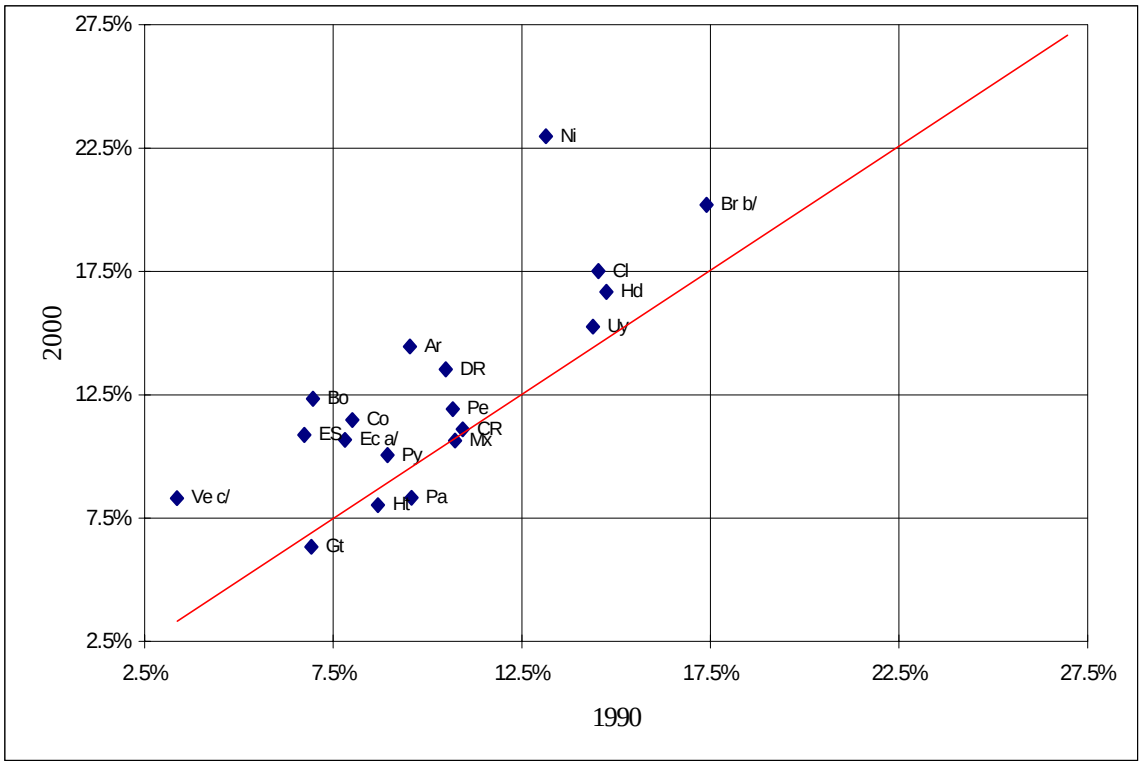
[3] The cyclically-adjusted deficit is defined as the fiscal deficit corrected for variations attributable to the business cycle. For this purpose, the GDP gap is calculated by estimating trend GDP, using the Hodrick-Prescott filter, and its effects in terms of public revenues and expenditure (Martner, 2000).

Figure 5.6
LATIN AMERICA (19 COUNTRIES): CENTRAL GOVERNMENT ACCOUNTS
(Percentage of GDP)



Source: ECLAC, on the basis of official figures.

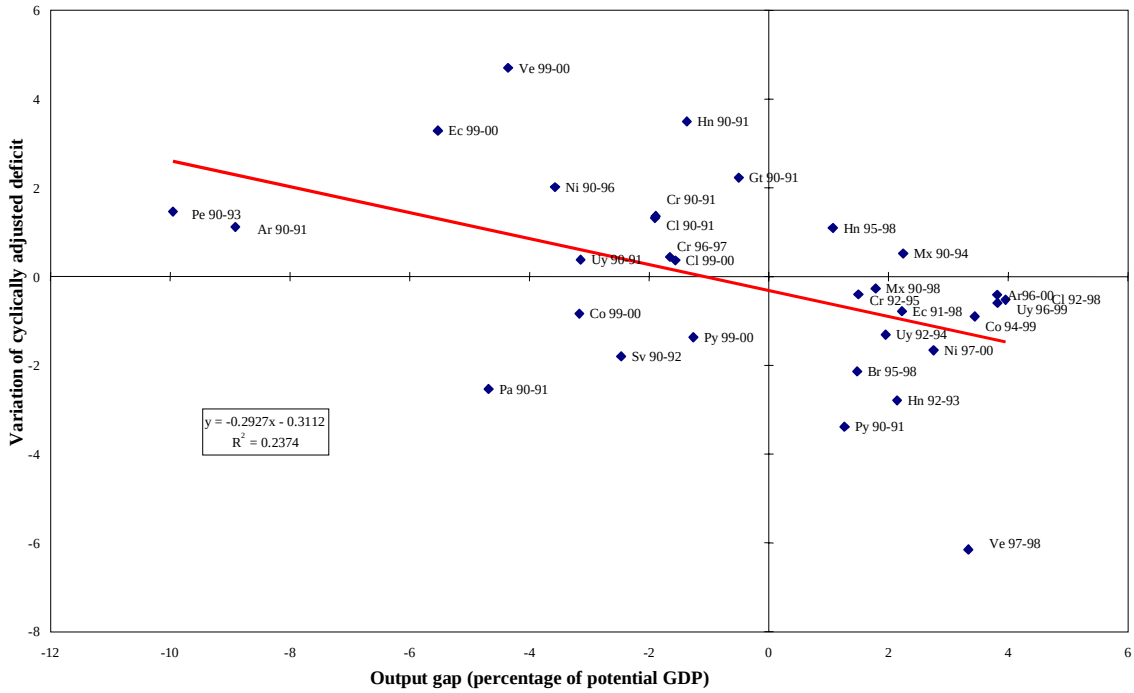
Figure 5.7
LATIN AMERICA: CENTRAL GOVERNMENT TAX BURDEN, 1990-2000
(Percentage of GDP, net of social security contributions)



Source: ECLAC, on the basis of official figures.

a/ The 2000 figure for Ecuador actually corresponds to 1999.
b/ The 1990 figure for Brazil actually corresponds to 1991. Includes state-level sales tax on merchandise and services (ICMS), but excludes the contribution to the financing of the social security system (COFINS), the Social Integration Programme - Public Service Assistance Plan (PIS/PASEP), the provisional financial transactions tax (CPMF) and the social contribution on net profits (CSLL), as these have been included under social security contributions.
c/ Figures for Venezuela include net oil revenues.

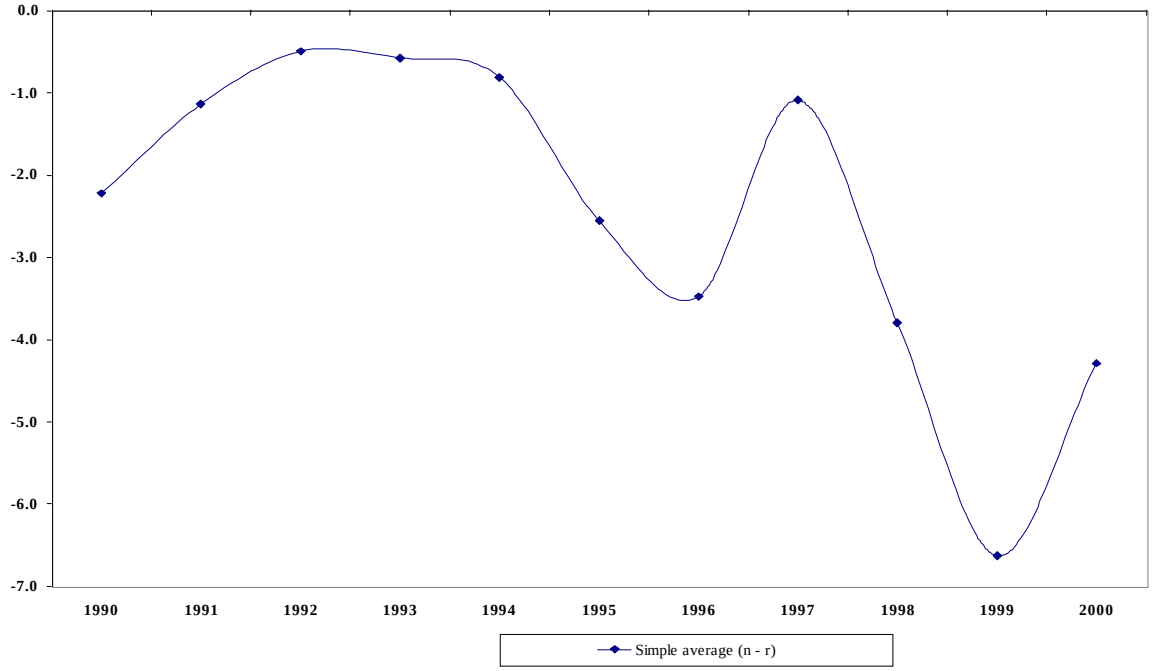
Figure 5.8
LATIN AMERICA: EPISODES OF PROCYCLICAL POLICIES, 1990-2000



Source: Ricardo Martner, *Estrategias de política económica en un mundo incierto: reglas, indicadores, criterios*, Cuadernos del ILPES series, No. 45 (LC/IP/G.123-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2000. United Nations publication, Sales No. S.00.III.F.1. Only includes episodes in which absolute values of the average annual output gap and the average annual variation of the cyclically adjusted deficit are larger than 0.25% for at least two years.

The procyclical behaviour of public finances has tended to become more pronounced as a result of certain features of prevailing monetary policies. Public-sector borrowing at real interest rates above the rate of economic growth causes the debt-output ratio to rise, thereby undermining the sustainability of public finances and resulting in less fiscal slack being available at times of crisis. As shown in figure 5.9, real interest rates on public-sector debt have been much higher than economic growth rates, particularly in recent years, and this has endangered public-sector solvency (see figure 5.9). As a result, a large and often growing proportion of fiscal revenues has been absorbed by interest payments in several countries (Argentina, Brazil, Colombia, Costa Rica, Ecuador).

Figure 5.9
DIFFERENCE BETWEEN RATE OF GROWTH OF GDP AND REAL INTEREST RATE PAID ON PUBLIC DEBT
(Regional average)

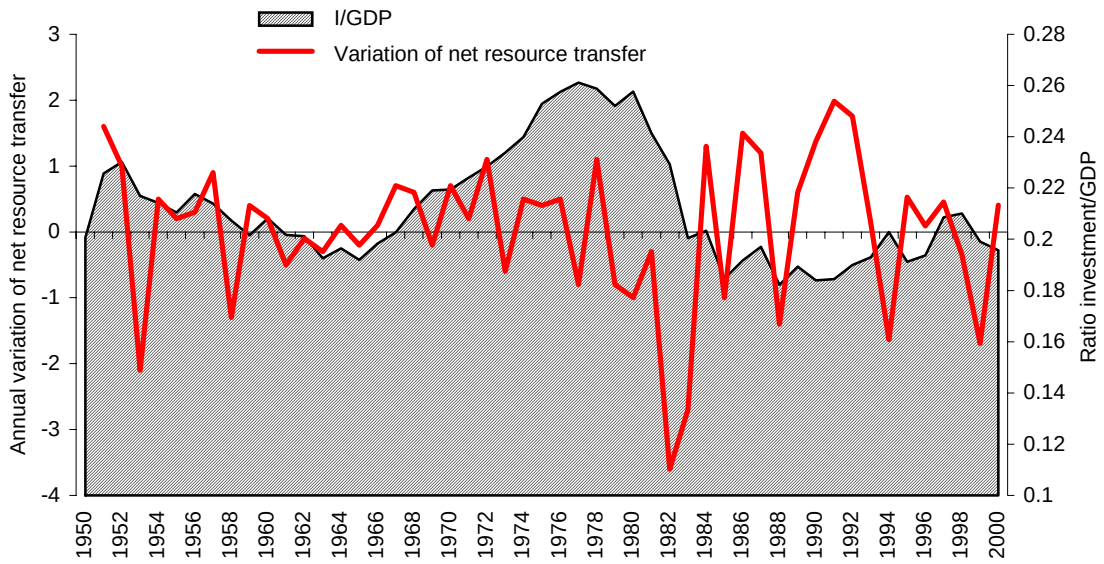


Source: ECLAC, on the basis of official figures.

3. Weak investment process and inadequate financial development

The instability of external financing has had a discouraging effect on investment. This is undoubtedly one of the reasons why the investment rate remains below pre-debt-crisis levels. The decline in the investment coefficient compared to the 1970s has been more pronounced in the larger countries, since these also have greatest exposure to private capital flows. The slight rise in investment seen during the 1990s was achieved thanks to greater external financing, but with no complementary growth in domestic saving and without greater access to long-term domestic or external financing for domestic investors, especially small and medium-sized ones. Figure 5.10 illustrates the weakness of gross capital formation throughout the region and highlights its sensitivity to external financial shocks.

Figure 5.10
LATIN AMERICA AND THE CARIBBEAN: VOLATILITY OF NET RESOURCE TRANSFER AND INVESTMENT/GDP RATIO



Source: ECLAC, on the basis of official figures.

Regression analysis to measure the determinants of investment behaviour in seven of the region's countries shows that a reversal of external capital flows equivalent to 1% of GDP generates a 0.64 percentage point drop in the investment/GDP ratio, as a direct result of the contraction in financing. Furthermore, if this reversal of flows becomes more volatile, provoking greater uncertainty among economic agents, it can induce a further 0.11 percentage point drop in the investment ratio. Other indirect effects of a reversal of flows stem from its effects on expenditure, through the Keynesian accelerator, and on the real exchange rate (Moguillansky, 2002).

Despite the significant changes that have taken place as a result of financial liberalization and the entry of major international financial intermediaries on regional markets, some of the most serious problems of domestic financial systems still persist. It is necessary to continue developing suitable schemes of prudential regulation and supervision in order to ensure adequate levels of solvency and liquidity among financial intermediaries. Shortcomings in this area, compounded by pronounced macroeconomic volatility, have shown through in the financial crises that affected at least 13 countries in the 1990s (ECLAC, 2001a). There has also been insufficient progress in developing long-term domestic saving and financing instruments and in guaranteeing adequate access to financing for business and social sectors that traditionally have been excluded.

The preference among banking systems for short-term financing has persisted. On top of this, intermediation spreads remain significantly wider than those seen in developed countries, which means higher financial costs for the domestic business sector or the need for excessive self-financing. Both of these factors discourage real investment and undermine international competitiveness. They have also strengthened the bias towards seeking finance abroad, but this has served to increase vulnerability associated with currency mismatches and has benefited the larger firms almost exclusively.

In several countries, pension reforms involving various modes of transition from pay-as-you-go to individual capitalization systems have encouraged domestic financial deepening and greater availability of long-term funds. Nonetheless, experience shows that it is hard to channel such resources into real investment, given the preference of these intermediaries, and the rules governing them, for investments of secure return and high liquidity.[4] Precisely for this reason, the development of a major market for long-term private-sector debt bonds and a liquid mortgage market is essential to ensure that adequate resources are channelled from these new intermediaries into productive investment. So far, measures intended to strengthen the equity market have proved frustrating in most countries. In some cases, the creation of financial instruments to stimulate long-term financing is resulting in the development of venture capital, investment and guarantee funds, together with loan insurance, although these remain deficient.

Having played an important role in the financing of economic development during the State-led industrialization phase, many development banks suffered major crises in the 1980s, and a good number of them disappeared. Nonetheless, some intermediaries of this type survived and continue to play a major role in the financial sectors of several countries (including Brazil, Chile, Colombia, Costa Rica and Mexico).

One of the priority activities of development banks during the last decade has been to channel resources towards microenterprises, small and medium-sized businesses, and the lowest-income households. This has given rise to new intermediaries, supported in many countries by multilateral and bilateral cooperation agencies. Despite this, the resources accessible to all these traditionally marginalized sectors remain insufficient.

III. The domestic domain: tackling the globalization of financial volatility through countercyclical macroeconomic policies

Faced with a globalized world and volatile capital flows, the authorities need to tackle financial risks by taking a broader view of macroeconomic stability. Objectives should no longer be confined to those that have monopolized their attention in recent years (control of the fiscal deficit and reduction of inflation), but should also embrace real goals, especially in terms of economic growth and its stability (ECLAC, 2000c, vol. III, chap. 1, and ECLAC, 2001e). Otherwise, it is highly likely that the volatility of external funding will continue to generate pronounced business cycles in developing economies.

In view of this, it is essential for domestic authorities to react prudently to periods of market exuberance, pre-empting situations of vulnerability while also leaving room for policy to cope with barren phases on international financial markets. Both the volatility of financial flows and the accompanying instability in economic growth rates have strongly discouraged productive investment, thereby undermining long-term growth. Instability in the real economy has been as negative for long-term growth as unstable price levels. Greater stability in the real economy in the short run, and stronger economic growth in the long run, are largely complementary goals therefore, but there are non-negligible conflicts between the two which tend to show through at critical moments.

Nonetheless, domestic authorities have limited autonomy in designing countercyclical policies, given the constraints imposed by the volatility of international financing. Accordingly, to expand possibilities for developing countries to adopt countercyclical macroeconomic policies, the domestic efforts mentioned in the previous section need to be complemented by improvements to the international financial architecture. Equally, analysis of the domestic aspects of this strategy,

[4] Moreover, bringing about the transition to these new schemes means running fiscal surpluses to cover the costs of paying pensions to retirees who remain in the old system, and fulfilling minimum pension guarantees (ECLAC, 1998c).

presented below, needs to be complemented by a study of the international factors considered in the final section of this chapter.

1. Prudential management of cyclical upswings: fiscal, monetary and regulatory aspects

Stable economic growth depends on the adoption of sustainable methods for directly influencing the key macroeconomic policy variables. This necessarily means taking a long-term view of policy design, avoiding the accumulation of unsustainable imbalances and taking advantage of the slack produced during expansionary phases to accumulate resources for coping with subsequent lean periods. The measures adopted to achieve this objective should concentrate on the fiscal, monetary and exchange-rate domains, along with prudential regulations, capital flows and the regulation and supervision of domestic financial markets.[5]

Coping adequately with the recurrent business-cycle vulnerability of public accounts requires public administration to be capable of responding to three fundamental challenges. The first of these is adherence to a long-term fiscal rule throughout the cycle, to avoid the economic and political costs of abrupt adjustments. This requires the development of tools to shift the budgetary process towards a framework of discipline and flexibility, clearly identifying transitory factors and ensuring fiscal management consistent with a financial position corrected for fluctuations in the level of activity and raw material prices. Secondly, it requires structural deficits to be identified well in advance to prevent excessive public borrowing from imposing a burden on future generations. This, in turn, requires multi-year fiscal programming, based on projections of the potential growth of the economy, with moderate assumptions being adopted that avoid "optimism bias" (in which positive episodes are viewed as permanent, while negative ones are assumed to be transitory), to ensure fiscal management that is more consistent in the long term. Thirdly, it is necessary to overcome the bias against capital expenditure, which stems from the fact that it is generally more sensitive to fiscal adjustments than current expenditure.[6]

Fiscal policy should be designed on a multi-year basis, with a long-term horizon defined on the basis of structural balance (or a small surplus or deficit), or else establishment of a target for the ratio between public debt and GDP. Despite progress made on budgetary programming, current fiscal-policy rules in many countries still tend to prioritize short-term targets that look no further than the annual cycle and lack clauses for coping with the unforeseen situations that are always occurring. In this regard, the passing of fiscal responsibility laws and the adoption of fiscal rules in some countries of the region in recent years are major steps in the right direction.[7] The achievement of countercyclical macroeconomic policy goals is also facilitated by the use of public-income stabilization funds, both for taxes and for revenues dependent on the price of raw material exports, when these are relevant. There are several outstanding examples of these in certain countries, which can be used as a basis for designing public-income stabilization funds of a general nature.[8]

Monetary and exchange-rate measures should aim to prevent periods of abundant external financing from causing excessive expansions of external and domestic credit and unsustainable

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5 The literature on the domestic macroeconomic management of financial volatility is extensive. Recent contributions include World Bank (1998, chap. 3), ECLAC (1998c, 2000c, 2001c), Ffrench-Davis and Reisen (1998), Furman and Stiglitz (1998), Helleiner (1997), Heymann (2000) and Ocampo (1999a, chap. 5 and 2002b).

6 Many countries are making major efforts to adapt their budgetary processes to the goal of stimulating and protecting public investment. For this purpose, it is helpful to plan and manage current and capital expenditures separately.

7 Starting in 1999, several of the region's countries (Argentina, Brazil, Ecuador and Peru) have passed fiscal responsibility laws that include multi-year targets and rules aimed at avoiding procyclical fiscal-policy behaviour. Similarly, Chile adopted a structural surplus rule making it possible to insulate public expenditures from transitory reductions in revenue.

8 Several of the region's countries have a tradition of using stabilization funds for revenues earned from raw materials (coffee and oil funds in Colombia; copper and oil in Chile; and oil in Venezuela). These have been added to general tax-revenue stabilization funds in the context of new fiscal responsibility laws. For a discussion of the usefulness of these general tax stabilization mechanisms, see ECLAC (1998b).

appreciations of the real exchange rate. This assumes a certain degree of discretion on the part of central banks to intervene on the foreign-exchange market whenever they detect strong pressures for currency appreciation; they also need to be able to intervene simultaneously in the money market to keep monetary expansion within the ranges needed to meet the inflation target, which usually acts as a monetary policy anchor. Such interventions may have two counterproductive effects, however. Firstly, they may result in high interest rates which attract capital inflows, thereby inducing a further appreciation of the local currency. Furthermore, if signs of crisis are already in the air, high rates may speed up financial deterioration and result in additional fiscal pressures (the cost of bailing out financial sectors and more costly domestic public borrowing, when this is on a large scale). In this type of situation, experience in the region has shown such policies to be more effective when they are accompanied by regulations on capital inflows, active prudential regulation and oversight of financial systems, and an explicit liability policy aimed at improving the time profile of public- and private-sector debts, whether domestic or external.

Given current levels of development in the region's capital markets, compounded by highly volatile capital flows and a deficient international financial architecture, full capital-account convertibility is not a first-best policy. On the contrary, tools for the prudential management of capital flows are desirable, whether direct (special deposits or taxes on external financing, direct regulation of portfolio flows) or indirect (tax rules).[9] The capital-account regulation schemes adopted by Chile and Colombia in the 1990s represent some of the best practices in this field.[10] As complementary tools of macroeconomic policy, the prudential regulation of capital flows gives the authorities extra room to adopt restrictive monetary policies during cyclical upswings and avoid unsustainable appreciation of the exchange rate; in the form of liability policy, they discourage short-term flows in particular, and make it possible to improve the structure of external financing.[11] Their advantages include the fact that they are applied to financial and non-financial agents alike, through a non-discriminatory price instrument.

Permanent schemes of prudential regulation, whose strictness increases or decreases over the cycle, are preferable to alternating between free capital entry and quantitative controls on outflows at times of crisis. In fact, the latter may prove totally ineffective if applied in improvised fashion during crises, since, instead of producing the desired effects, it can lead to massive avoidance or evasion of controls and a loss of policy credibility.

Strict control over mismatches between foreign-currency assets and liabilities in the financial system is an essential element of any prudential regulation arrangement. Nonetheless, direct access to external credit by non-financial firms, especially the larger ones, undermines the effectiveness of such rules in preventing mismatches between foreign-currency assets and liabilities throughout the economy as a whole. Mismatches accumulated by non-financial agents during times of expansion also affect the soundness of the financial system, because it is difficult to cover the local-currency liabilities that non-financial agents with debts abroad will subsequently face.

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[9] This point of view reflects a long tradition at ECLAC. Some of the most rigorous analyses of unstable capital flows and policies for managing them before the "tequila crisis" were done by ECLAC in 1994. See the second edition of the report prepared at that time by ECLAC (1998b, part III). In addition, UNCTAD (1998), United Nations (1999), Akyüz and Cornford (1999), Eichengreen (1999), Griffith-Jones (1998), Griffith-Jones and Ocampo (1999) and ECLAC (1999e) all provide expositions on the advisability of imposing restrictions on capital flows, in a world characterized by an imperfect financial safety net.

[10] Chile and Colombia have successful experience in managing capital flows through the imposition of unremunerated reserve requirements on financial flows. Up to May 2000, Chile also required portfolio and direct investment inflows to remain in the country for at least one year. Colombia regulates such investments directly.

[11] Studies on the topic conclude that this instrument has had positive effects on the term structure of external debt by raising the cost of short-term borrowing without significantly affecting longer-term flows (Agosin and Ffrench-Davis (2001); Agosin (1998); Le Fort and Lehmann (2000); Ocampo and Tovar (1999); and Villar and Rincón (2000)). Some studies also suggest that the use of special deposits has made it possible to effectively reduce capital inflows, or equivalently, give a wider margin for sustainably raising domestic interest rates or changing expectations of devaluation, or both of these objectives simultaneously. Such effects have been the subject of major controversy, however. Valdés-Prieto and Soto (1998) and de Gregorio, Edwards and Valdés (2000) present a contrary view.

The alternative of combining instruments for prudential regulation of financial intermediaries with explicit tax mechanisms to discourage foreign borrowing by non-financial agents, among other taxes on firms' net foreign-currency borrowing (Fischer, 1998), may be an effective substitute. This type of measure does not cover borrowing by private individuals, however, nor does it apply to stock-market investments. Moreover, the design of flexible taxes on non-financial firms' foreign borrowing is much more complex than the regulation of capital flows at the border.

2. The exchange-rate regime

The most important lesson to be drawn from events in the region and in the world at large over the past few decades is that there is no exchange-rate regime that is optimal for all countries at all times.[12] Each country has to decide the degree of nominal exchange-rate flexibility it requires, according to its objectives and real possibilities for managing the other macroeconomic policy variables.

Contrary to this opinion, in the 1990s a belief developed that the only stable exchange-rate regimes in the current phase of globalization are those at the two ends of the spectrum —either a fully flexible regime, or a "hard anchor" for the exchange rate (currency board or dollarization). This view is based on the susceptibility of soft anchors and managed flexibility to speculative attacks stemming from a perceived inconsistency between exchange-rate policy and policy in the rest of the economy. Such reasoning points up a real problem, namely the difficulty of maintaining fixed exchange rates (soft anchors and, in some cases, hard anchors too) in the face of major expectations of devaluation. The main problem currently faced by exchange-rate regimes in developing countries, however, is their capacity to manage trade shocks and fluctuations in the capital account, which are largely *exogenous*, and at the same time prevent them from resulting in more pronounced economic cycles, or in incorrect or unstable relative prices that discourage development of the economy's tradable sectors. The contradictory demands of flexibility and stability required to fulfil these complex objectives can only be responded to under extreme regimes, forgoing some of their elements.

A nominal anchor, accompanied by prudent fiscal and monetary policies, contributes to price stability and, consequently, to real exchange rates that provide stable incentives to the economy's tradable sectors. Nonetheless, the volatility of capital flows tends to inject major instability into the domestic activity of countries adopting this type of exchange-rate regime. In addition, the absence of mechanisms to facilitate relative price adjustment in the face of negative external shocks (falling export prices, devaluation of the currency of a major trading partner, or revaluation of a currency to which the country's own exchange rate is linked) may entail high adjustment costs, including long periods of recession or slow growth caused by a structurally overvalued exchange rate. Given the weak control of the money supply that this type of regime entails, the central bank cannot exercise the functions of "lender of last resort", and this creates major problems if crises affect the domestic financial system.

In contrast, flexible exchange rates allow the economy to absorb international trade and financing shocks. They also make it easier to adopt a monetary policy aimed at stabilizing the business cycle, and partially discourage short-term credits and certain types of portfolio flow. They do not help mitigate medium-term financing cycles, however. On the contrary, expected fluctuations in the real exchange rate can actually accentuate such cycles (Ffrench-Davis and Ocampo, 2001). Fluctuations in the real exchange rate usually send contradictory signals about tradable goods- and service-producing sectors, which discourages investment in them. When major monetary mismatches occur, fluctuations in the exchange rate have wealth effects (gains from

[12] Frankel (1999), Hausmann (2000), Velasco (2000) and Williamson (2000) provide more detailed analyses of the issues discussed in this section.

appreciation during the upswing and losses from devaluation during crises) that accentuate the business cycle.

The great virtue of intermediate regimes, of "managed flexibility", is their potential to reconcile flexibility with stability. Examples of such regimes include crawling-peg mechanisms, currency bands, the establishment of indicative targets or bands that the authorities are willing to partially defend, and dirty floating. All these regimes involve some degree of flexibility, making it possible to absorb external shocks and adopt counter-cyclical policies, while also aiming to provide more stable incentives for international specialization. In this context, the desired level of flexibility will basically depend on the size of the economies concerned (greater flexibility is desirable in the larger economies), the depth of domestic financial and foreign exchange markets (greater flexibility in countries with greater domestic financial depth), and the degree of capital-account openness (greater flexibility when capital accounts are more open).

As this latter condition suggests, effective management of intermediate regimes may require active regulation of capital flows to manage the pressures arising from international financing. Such schemes can also come under speculative pressure when macroeconomic policy as a whole fails to inspire the necessary credibility. For this reason, more flexible intermediate regimes have an advantage, particularly in larger economies with open capital markets.

3. "Self-insurance" mechanisms

Another way of promoting stability is to keep an adequate level of liquid funds (current or contingent) available to absorb transitory negative external shocks and prevent speculative attacks on the local currency. All countercyclical policy requires resources to be accumulated during boom periods (both external and fiscal, and slack in the financial system), to be used later in times of scarcity. Nonetheless, the accumulation of international reserves may prove very costly, because, as recent crises have shown, net capital outflows can amount to several percentage points of GDP. The costs of such reserves need to be weighed against the expected benefits of their role as a self-insurance mechanism.

Some countries have tried to achieve this same objective by negotiating contingent credit lines with international private-sector banks; but the market for these is still incipient and the amounts available may be inadequate at times of acute crisis, especially those involving contagion phenomena. This suggests that the most appropriate mechanisms are collective insurance schemes based on the provision of international liquidity through multilateral mechanisms and regional arrangements, as discussed below

4. Prudential regulation and supervision of financial systems

In recent years, unstable domestic financial systems have triggered or propagated external crises and fluctuations throughout the rest of the economy. Globalization has also shown that systemic risk is correlated across countries, and this has led the international financial community to encourage adoption of suitable prudential regulation systems, governed by internationally accepted recommendations, particularly those drawn up by the Basel Committee on Banking Supervision.

Strengthening the stability of domestic financial systems requires progress to be made on five fronts: (i) improving regulation and oversight of credit, currency and market risks in the commercial banking sector; (ii) strengthening the regulation of financial conglomerates; (iii) restricting concentration in the banking system, since oversized banks can suffer from moral hazard in the sense of being considered "too large to go under"; (iv) improving criteria on the presence of foreign financial institutions that are not subject to reliable supervision and consolidated regulation of conglomerates in their home country; and (v) tightening regulations on the first-tier State banking

system to require adherence to market standards when evaluating portfolio quality, similar to those applicable to private commercial banks.[13]

Apart from strengthening the solvency of financial systems, banking regulation and supervision aims to provide space for countercyclical policy. Spain has adopted regulatory standards for this purpose, aimed at evaluating credit risk over a horizon encompassing the whole business cycle. Their purpose is to eliminate or partly offset the procyclical effect of traditional rules for assessing and prudentially providing against risk. These lead to underestimation of risk and hence excessive credit expansion in the upswing phase, but also the need to maintain substantial reserves against doubtful loans at times of crisis, thereby intensifying the credit drought characteristic of such periods. This type of regime should be generalized and complemented with exceptional prudential provisions and stricter rules for risk-rating during expansionary phases, especially in the case of financial institutions whose portfolios grow very rapidly. It would also be a good idea to place a limit on the value of equity and real estate that can be used as loan collateral. On the other hand, during recessions it is important to prevent regulatory standards from accentuating credit constraints and the lack of liquidity among economic agents, by establishing mechanisms that make it possible to apply stricter prudential standards gradually over time.

5. Domestic financial development

Stable and deep development of domestic financial systems has positive effects for saving and the financing of investment, and reduces the vulnerability of economies to external financing cycles. The development of active markets for equities, financial derivatives and both public and private debt, together with securitization, secondary mortgage markets and the establishment of other regimes aimed at risk diversification, as well as increasing participation by institutional investors such as pension funds, insurance companies, mutual funds, and investment and venture-capital funds are some of the many examples of this process.

Any policy adopted for this purpose should also make it possible to overcome market failures, and even the lack of markets, or certain segments or components thereof. This gives a key role to institutional development policies aimed at creating regulatory conditions that encourage the emergence of new market segments and financial intermediaries, and also much more direct participation by the State in this process, preferably as a catalyst for increasing participation by the private sector.

The financial development process assumes conditions of macroeconomic stability that are consistent with the goal of lengthening maturities on financial saving and creating instruments through which this can occur. It also requires adequate protection of financial contracts against inflation risks. One of the main ways of achieving this is by index-linking long-term financial instruments and contracts.

The liquidity of an instrument is directly related to the breadth of its market; in other words, the presence of multiple agents capable of absorbing fluctuations in the supply and demand for securities without excessive variations in their prices, thereby stabilizing markets. This underscores the need to support the development of secondary debt markets and "market makers" (investment banks or other intermediaries authorized to act as such) to play this stabilizing role. Given their characteristics in terms of quantity, uniformity and lower risk, domestic public-debt securities tend to act as market leaders and benchmarks for other instruments. A lengthening of the maturities applicable to such securities could therefore help extend the time horizon of the market as a whole.

As they contain real guarantees and allow greater homogeneity in the securities traded, securitized mortgage loan packages can also promote market development, especially for longer-

[13] Held (1994), ECLAC (1998b, chap. XII) and Livacic and Sáez (2000) develop these arguments further.

term securities —in this case provided there are institutions that effectively perform the securitization and market-making function. Two publicly owned agencies, known as Ginnie Mae and Fannie Mae,[14] played a key role in the United States in setting up a market such as the one described.[15] The strong development of the mortgage lending system in Chile is associated with the creation of an indexed unit of account, which makes it possible to protect long-term financial saving from the effects of inflation.[16] The development of new institutional saving agents in the wake of pension system reform in 1981, and the recovery of bank solvency after the banking reform that followed the financial crisis of 1982-1986, gave rise to an active market for financing long-term operations based on securitized mortgage instruments. In both cases, public policy proved crucial in setting up the institutional structure needed to deal with important aspects of the financing of activities that require longer horizons.

When economic agents act as financial investors —in other words, when they are not directly involved in real investment activities— the need for risk management is crucial. In some cases this is performed by specialized institutions. The function of risk rating and control tends to be carried out by a "first-tier" institution, which applies standardized procedures for assessing the risks of direct investors and reduces portfolio risk through diversification. This is backed up by investors' payment capacity and, in the case of housing, is guaranteed by mortgages. The first-tier institution consolidates a number of individual loans and offers them to the market as a single financial asset. When these are acquired by institutional investors, commercial credit risk (the probability of the original debtor defaulting) is confined to the first-tier institution, since the rating gives it comparative advantages. Meanwhile, financial risk (the likelihood that future interest rates will differ from current ones, causing the prices of the assets in the portfolio to fluctuate) is shifted to the financial investor. In both cases, regulations are needed, along with other capital requirements and provisions guaranteeing the solvency of the investing intermediary.

Mechanisms for hedging the risk of losses, which facilitate the development of long-term lending, also have an important place in the institutional structure. Examples are guarantee funds and loan insurance, aimed mainly at hedging commercial risks. Financial risks can also be covered in a deep secondary market through the development of an active market for financial derivatives. In this case, accounting rules should clearly and transparently reflect the assets and liabilities underlying the respective operations, in order to determine the corresponding capital requirements.

Since not all intermediation involves banking activity, there is a need for oversight of the distribution of tangible and intangible assets between the banking sector and the associated financial activities. This requires consolidated supervision schemes for financial conglomerates or, at least, for the subset of activities of a banking consortium. Transparency, the provision of timely and reliable information, and governance of the management of third-party funds and resources to safeguard the property rights and trust of non-controlling owners are fundamental.[17] Transparency is another relevant factor for proper management of firms' corporate ownership. Primacy of the property rights of investors in institutional funds compared to those of their managers, and equality of property rights —although not management rights— between minority and controlling shareholders, are two aspects that should be given priority in the construction of a regulatory framework aimed at developing deeper domestic capital markets in the region.

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[14] The official formal names of these institutions are Government National Mortgage Association and Federal National Mortgage Association, but they are usually referred to by the nicknames mentioned in the text.

[15] In 1970 Ginnie Mae introduced the world's first securitized asset for housing finance, thereby creating a new market. At the same time, the government withdrew from Fannie Mae, thus giving a major boost to private participation in a market that previously had been promoted by the public sector.

[16] Argentina, Colombia and Uruguay have also often used index-linked financial assets for housing finance.

[17] The following are essential for this purpose: accounting records; periodic audits that are independent and reliable; the establishment of oversight committees; independent risk rating; separate accounting of fund managers' own assets from those of the third-party fund; and capital requirements for fund managers, the level of which should be sufficient to inspire trust in their solvency to protect investors' funds in the event of management contingencies and failures.

Establishing an appropriate regulatory framework may be insufficient to ensure access to credit for small firms and those investing in innovative areas. In the first case, a lack of collateral usually limits SMEs' access to credit, while in the second case excessive caution with respect to risk holds back real investment. Public support takes a variety of forms, but its aim is always to limit exposure to the risk of losses. The establishment of guarantee funds with both public and private participation, and subsidies for loan insurance premiums, are possible mechanisms for covering and absorbing the credit risks of smaller firms. In addition, institutions such as venture capital companies, also with public-private participation, may prove useful for funding investments by small firms.

A strong public development-bank sector could become an important component of a financial development policy such as the one described. In a modern version, public agents such as these should engage primarily in creating and completing markets, in accordance with the guidelines indicated. As regards their more traditional functions, they may also participate directly in lending activities. This is very important in order to guarantee adequate access to credit for smaller firms, in conjunction with other private, cooperative and solidarity-based intermediaries. Frequently, banks of this type offer new and small-scale clients their first chance to create a financial track record, after which they can graduate to the banking sector in the private market. In this way, they enable informal activities, small-scale farm owners, technological innovators, and small and medium-sized firms in general to gain access to banking services in the normal way.

The market can make a major contribution to permanent and continuous scrutiny of portfolio risk, when the development-bank sector is an autonomous extrabudgetary institution taking in third-party funds, without State guarantee, and when it is periodically subject to portfolio risk rating by the Superintendent of Banks and other agencies. To strengthen payment collection policies, they can be organized as first-tier commercial banks subject to private banking regulation and oversight procedures. For this they would need to make their commercial operations more transparent, improve their collection policies and rapidly detect the financial effects of short-term political pressures. They could also be organized as second-tier banks and deal with the problems of targeting, improving financial resource bidding rules and applying a combination of rate subsidies for partial loan insurance premiums, or, alternatively, operating partial guarantee funds and providing subsidies for credit risk rating by first-tier intermediaries and training in project management and design for potential beneficiaries. Subsidies and transfers should be subject to appropriate social and economic evaluation, and be well designed and operationally transparent; in addition, the fiscal cost they involve should be explicit and financed with properly budgeted public funds.

IV. The international domain: strengthening the governance of financial globalization

In the previous chapter it was argued that achieving greater international financial and macroeconomic stability should be seen as a global public good, offering positive externalities to all countries participating in world markets. This argument highlighted the crucial role played by strong international financial institutions in correcting the glaring disparities that exist in financial market development and asymmetries in the macroeconomic behaviour of industrialized and developing countries.[18] These asymmetries stem from a structural feature shared by all developing

[18] The literature on the issues dealt with in this section is abundant. On the concept of "global public goods" applied to the international financial system, see Helleiner (2000a), Kaul, Grunberg and Stern (1999) and Wyplosz (1999). On international financial reform, see, among others, IMF (1998, 1999a and 2000a), ECLAC (1999e), United Nations (2000b), UNCTAD (1998), Akyüz and Cornford (1999), Eatwell and Taylor (2000), Eichengreen (1999), Fischer (1999), Griffith-Jones and Ocampo (1999), Ocampo (1999a and 1999b) and White (2000).

economies, namely the fact that their currencies are not used as an exchange and reserve assets in international transactions. This asymmetry puts them in an unfavourable position to cope with the volatility that characterizes financial globalization, because it induces unstable access to international markets and a procyclical bias in macroeconomic policies. Overcoming these problems requires sound domestic policy-making, backed by an international institutional framework that supports efforts in that direction.

The components of the reforms needed to achieve this objective were summarized in the previous chapter. This one describes some of them in more detail, in particular the following: (i) development of an international and domestic financial institutional framework to prevent the build-up of excessive financial risk and provide adequate information to markets; (ii) building capacity to respond in timely fashion to the crises that threaten international financial stability; (iii) solution of overborrowing problems and equitable distribution of the costs of crises between lenders and borrowers; (iv) the role of the multilateral development bank sector; and (v) enhancement of the role of regional and subregional institutions in all these fields.

1. Creation of an institutional framework promoting financial stability

International financial stability requires minimum standards on two key issues: prudential regulation and oversight of financial systems, and the supply of information needed to enable authorities and financial markets to function properly. Although these issues are being analysed in the Financial Stability Forum set up by the Group of Seven, developing countries are inadequately represented in this mechanism. The relevant standards need to take into account different countries' absorption capacities and regulatory conditions. Given the global nature of markets, there is a need to move forward simultaneously in the direction of better coordination and greater communication between the supervisory bodies of the various countries.

Prudential regulation and supervision should aim to pre-empt systemic problems by preventing financial agents from assuming excessive risk and ensuring that their assets are proportional to the risks assumed. The strictness of the rules should be consistent with the risks that agents assume jointly as well as individually. This implies the need to expand the boundaries of supervision in two directions: firstly, to non-financial agents that have asset-ownership relationships with financial agents, which will require a move towards consolidated supervision of conglomerates; and secondly, to nonbank financial agents such as mutual funds. In the case of industrialized countries, stronger emphasis should be placed on regulation and supervision of institutions and operations displaying the highest levels of leverage and greatest international presence. In addition, to discourage high-risk financing in developing countries at source, particular importance should be given to risk rating in operations carried out with countries that increase their net borrowing, especially short-term, and to a disproportionate extent in relation to the size of their economies, financial sector and reserves available to service their external liabilities. Moreover, all countries need to take effective steps to prevent and penalize money laundering and other financial crimes, following United Nations recommendations on these issues.[19]

Major challenges still remain on the issue of financial system regulation and oversight. The Basel Committee proposal to provide against risks of expected losses and establish minimum capital requirements using internal ratings-based models, instead of the current practice of using standardized criteria, could raise the cost of international bank lending to developing countries and accentuate their procyclical behaviour (Reisen, 2001b; Griffith-Jones and Spraat, 2001). In addition, establishment of a regulatory system such as the one proposed could change the conditions of banking competition internationally. The greater development and sophistication of banks in

[19] See Blum and others (1998) and United Nations (1998).

developed countries would put them at an advantage, since their portfolio costs and the capital requirements applicable to them would be lower. Any reform of international regulatory standards should strive to avoid such effects.

Efforts to standardize the quality, quantity and transparency of the financial and accounting information received by economic agents are intended to improve market efficiency and the stability of capital flows (Ahluwalia, 2000). One of these, in which nearly 50 countries are participating, involves development by the International Monetary Fund (IMF) of standards for the quality and timeliness of economic and financial information provided to markets. The International Standards of Accounting and Reporting (ISAR) being studied by the United Nations Conference on Trade and Development (UNCTAD) represent another praiseworthy initiative that may lead to more uniform accounting between countries. The International Accounting Standards Committee has also developed a set of basic criteria for adoption by the International Organization of Securities Commissions (IOSCO) to help develop deep and transparent international capital markets.

The provision of transparent information undoubtedly helps markets to function better. The key problem is not a matter of imperfections in the factual information on which economic agents base their operations, but the volatility of their opinions and expectations (Ocampo, 1999a; Eatwell and Taylor, 2000). Often, basic information on the macroeconomic conditions of developing countries has been available, but has been interpreted differently at different times, depending on economic agents' expectations. This has even been true of the agents that are supposedly best informed, namely investment banks, risk-rating agencies, intergovernmental organizations and governments themselves.

Risk-rating agencies require special mention in this context. As private-sector institutions responsible for providing information to investors, their performance has been far from satisfactory. Their characteristically procyclical pattern of risk assessment[20] was one of the factors underlying the volatility of opinions and expectations held by economic agents operating in emerging markets during the pronounced cycles of financial expansion and collapse in the 1990s. Instead of smoothing out financial cycles, which should be one of the aims of a good information system, they have actually tended to intensify them.

Consequently, rules are needed to force such institutions to classify sovereign risk according to publicly known, strict and objective parameters. Such principles could serve as a basis for the establishment of frameworks for regulating and supervising their activities and for the development of mechanisms for exchanging information between them and the regulatory bodies. One alternative worth considering is the possibility of complementing the sovereign risk-rating that these agencies currently perform with a rating system applied by supervisory bodies in the countries of issuance, according to objective and internationally agreed parameters.

2. Emergency financing

Unlike the systems that have developed over more than a century in individual countries, the international financial system does not have suitable instruments for coping with crises. These include the central-bank function of "lender of last resort", preventive mechanisms for intervening in ailing financial institutions, deposit insurance and rules for the refinancing or liquidation of institutions in financial difficulties. The purpose of such mechanisms is to preserve the integrity of the payments system and prevent economic and social losses arising from haphazard and unfair management of financial crises. Although such instruments were designed to respond to crisis situations, they also act preventively by helping to prevent destabilizing expectations from arising and leading to systemic crises.

[20] The recent cases of Enron and Kmart show that this problem is common to corporate risk-rating activities.

With respect to the growth of the international financial market, IMF has been left behind, for while it can create money to generate liquidity by issuing special drawing rights (SDRs),[21] the exceptional funds needed to handle the most serious crises of recent decades have depended on arrangements to borrow. These allow IMF to obtain loans from the main industrialized countries, along with bilateral contributions from these countries to complement the corresponding bailout programmes. The uncertainty caused by this procedure undermines the Fund's capacity to send signals that bolster confidence (Eichengreen, 1999; Ocampo, 1999a; Rodrik, 1999a). The first of the main innovations made during the 1990s involved the creation of an emergency funding mechanism enabling IMF to respond rapidly in serious crisis situations. The other two correspond to new services: the Supplemental Reserves Facility, designed to respond to exceptionally large financing needs, and the Contingent Credit Line, designed to help countries suffering from financial contagion phenomena. The first of these facilities has functioned relatively well, but the second has not produced the expected results. To gain access to this credit line, countries have to sign a contingent agreement, but, given the potentially negative signal that this sends to markets, and the small amount of resources available, it is hardly surprising that no country has yet applied to make use of the facility. One possible modification could be to provide automatic access to this credit line to countries that receive a positive rating in the consultations held under article IV of the IMF Articles of Agreement.

The potential benefits of IMF support for countries that have satisfactory macroeconomic fundamentals, but face capital flight that threatens to destabilize their economies, are so important that they justify continued efforts by the international community to find better ways to perfect and develop the mechanisms analysed (see proposals by Williamson, 1996; Ezekiel, 1998; and Ahluwalia, 1999, among others). A facility containing sufficient funds for these purposes, with rapid and automatic disbursement, would make it possible to change the international regime and the behaviour of economic agents by sending out a powerful signal discouraging speculative behaviour. This is the right way to turn the Fund into the "international quasi-lender of last resort" that the current phase of financial market globalization requires.

To achieve this aim and respond flexibly to financing needs during periods of crisis, IMF resources require considerable expansion. Possibly the most appropriate of the available alternatives would be to make temporary issues of special drawing rights in crisis periods, which would be available to all member countries. These temporary issues would be eliminated later, unless it was desired to create permanent liquidity.[22] Of course, greater use of SDRs in the international financial system is an objective in itself, long advocated by developing countries; it should not be conditional on the adoption of specific credit lines.

Macroeconomic programmes adopted in the IMF framework should be governed by a consideration of their effects on the most vulnerable sectors of the population, not only through adequate social safety nets, but also through macroeconomic adjustment measures that take their social impact into account. As always when conditionality is applied, a principle to be observed is that adjustment policies should be effectively supported by the domestic authorities, in accordance with the principle of ownership. Apart from anything else, this principle is essential to guarantee appropriate institutional development and the sustainability of adjustment measures.

3. The solution to problems of overborrowing

In the absence of an emergency financing facility that partly acts as an international lender of last resort, crisis-hit countries must drastically adjust their economies or unilaterally suspend both

[21] All SDR issues must be explicitly approved by the IMF Executive Board, with a majority of 85% of the votes. The last issue was made in January 1981.

[22] See United Nations (1999), Ocampo (1999a), Council on Foreign Relations (1999), Meltzer and others (2000), and Camdessus (2000). With respect to the two last-mentioned, see Ezekiel (1998) and Ahluwalia (1999).

debt service and capital outflows. Both of these alternatives can have a high cost in terms of growth, employment and poverty. To avoid the costs of these unilateral measures, organized multilateral rules need to be designed to deal with this type of problem.

For countries that have solid macroeconomic fundamentals but suffer from liquidity problems, the first line of defence should be emergency financing. This gives them the breathing space needed to adapt the time profile of their external obligations. External support is crucial in such cases, to prevent a temporary illiquidity situation from degenerating into insolvency in the wake of irrational panic among the investor community. A temporary suspension of external payments should only be necessary in extreme cases. Alternative mechanisms that have been used during some recent crises (by the Republic of Korea and Brazil, among others) include pressure from the regulatory authorities of industrialized countries to persuade commercial banks to renew their credit lines to affected countries.

On the other hand, in cases of insolvency, renegotiation and possibly a reduction in liabilities is an imperative need, where delay will harm debtors and creditors alike, and can also result in an inequitable distribution of crisis costs among the latter (i.e., between those who withdraw their capital early and those who keep it in the country during crisis periods). Even in such cases, as indicated below, the renegotiation of external obligations should be a complement rather than a substitute for emergency financing.

Any institution that considers itself international in this field should uphold voluntary negotiation between the parties as a basic principle. At the same time, however, multilateral rules are needed to give legal force to the suspension of payments and debt renegotiation, and allow the country to tackle the two basic problems of coordination that arise in negotiations of this type. These are: (i) the possibility that some lenders, and even borrowers, may refuse to participate in the solutions proposed (the free-rider problem); (ii) the potential slowness of the process or the successive negotiations, which impose high costs on debtors and creditors alike (a negative-sum game).

To solve the first of these problems, loan contracts need to contain collective action clauses, whether in the case of sovereign bonds, bonds issued by private institutions or loans extended by the private banking sector. Such clauses should include rules to ensure that certain agreements apply to all obligations.[23] The clauses should be of a universal nature, also applicable to debt contracts entered into by industrialized countries, to prevent markets from punishing the countries using them through higher interest rates or more restricted access to funds.

Suspensions of payments should be decreed by the debtor country and be complemented with restrictions on portfolio capital outflows. They should also be sanctioned by a multilateral institution, in order to give them legitimacy and legal force. This is also important to avoid moral hazard problems among debtors; that is, unjustified declarations of moratorium. The International Monetary Fund could participate in such operations, recommending that countries should use this mechanism and possibly acting itself to legitimize suspension of payments. Some analysts consider that IMF already has powers to take measures of this type under article VI. In addition, the Fund should continue its practice of granting loans to countries that have fallen behind in their payments but are making efforts in the right direction (lending into arrears), as this encourages creditors to cooperate in solving crises.

To avoid prolonged and repeated negotiations, it would also be helpful to design mediation mechanisms and, where necessary, a multilateral arbitration procedure which the parties could voluntarily apply to settle disputes in debt refinancing or renegotiation processes. As a creditor, IMF is not the appropriate institution to fulfil these functions, which should therefore be assigned to

[23] There are important precedents for the mandatory introduction of this type of clause in debt contracts, especially in bond issues in the British market (Griffith-Jones, 1998).

another institution within the multilateral system. Negotiations and agreements should be wide-ranging and cover liabilities in both the private and public sectors. It would also be useful to encourage the adoption of flexible agreements, contemplating relatively foreseeable contingencies, in order to avoid renegotiations and explicitly encourage creditors to continue extending funds to countries in difficulties during critical periods. Such lending could be linked to restructuring programmes in some cases. Financing extended to countries during crisis periods should be given priority in any restructuring.

In the period following the successful conclusion of debt restructuring, countries will not have access to private capital markets. Agreements need to take this situation into account by providing grace periods for servicing the restructured debt. Multilateral banks have a crucial role to play during this period, by providing additional funding. As the key objective of restructuring programmes is to help countries get back into private capital markets, one scheme that would be worth studying involves setting up multilateral bank guarantee funds for this very purpose.

4. The role of multilateral development banks

Multilateral development banks, such as the World Bank, together with its regional counterpart the Inter-American Development Bank (IDB) and subregional ones such as the Andean Development Corporation (ADC), the Central American Bank for Economic Integration (CABEI), the Caribbean Development Bank (CDB) and the Financial Fund for the Development of the River Plate Basin (FONPLATA), have played a decisive role in lending to countries, especially the relatively less developed ones, that have no access to private capital markets. In the case of countries that do have access to such markets, especially middle-income countries, multilateral development banks also play an important role in providing countercyclical financing to cushion the effects of external shocks.

This type of support has been a complement rather than a substitute for the balance-of-payments financing provided by IMF and a number of bilateral sources, particularly as development banks are the only long-term financing sources available at times of crisis. For that reason, they make it possible to moderate the necessary fiscal adjustment, set up social safety nets for the most vulnerable sectors and avoid cutbacks in critical social programmes. Support from such institutions has played a major catalyzing role in maintaining and restoring confidence in countries during crisis periods, and hence in renewing private capital flows, which is no less important. Such characteristics have made development banks a highly valued asset for shareholder governments in developing countries, as is reflected in the commitments assumed during their capitalization processes.

Multilateral financing also has undeniable advantages in terms of its conditions, since the corresponding loans are granted for longer periods and at lower interest rates than those offered by private sources. These characteristics are particularly pronounced in the case of the new commitments aimed at relatively less developed countries, a fact which, together with the greater importance of such resources for these countries, highlights the preferential treatment these institutions provide. Such treatment also extends to the region's relatively higher-income countries.

The low risk classification characteristic of multilateral banks stems from a mix of developing countries' commitment to meet their obligations to them, backing from developed countries in the case of the World Bank and IDB, and conservative management of their asset-capital and portfolio concentration ratios. Even those that do not receive contributions from industrialized countries have a lower risk rating than the countries of the region, which enables them to gain access to external funds at a lower cost than the countries themselves can. The case of the Andean Development Corporation (ADC) is highly significant in this respect, since its shareholders consist exclusively of developing countries in the region. This fact, together with the strong portfolio quality generally displayed by multilateral banks, suggests that private agents tend

to overestimate the main risk, though not only during crisis periods. Overestimation of risk represents a market failure that, in itself, justifies the action of multilateral development banks.

The loan portfolios of regional and subregional institutions have a diversified profile that varies from one institution to another. These institutions have tended to prioritize social development projects, and have played a pioneering role in funding sustainable development programmes and channelling resources towards traditionally excluded productive sectors, particularly small and medium-sized business. At the institutional level, it is also worth mentioning their support for State modernization programmes. In addition, they are involved in the development of physical infrastructure, certain productive sectors and, in some cases, foreign trade operations, especially those related to integration processes.

These institutions use three mechanisms in their role as catalysts of private financing: (i) guaranteeing timely payment on public debt, or the timely payment of liabilities (in the form of guarantees or subsidies) assumed by the State in support of private projects; (ii) direct financing or co-financing of innovative private projects, contributed directly by the bank or by the relevant financial corporation; and (iii) venture capital provided by the financial corporation to innovative firms. These mechanisms have served as catalysts for private-sector investments in infrastructure. There have also been a number of pioneering operations to guarantee public debt service on bond flotations made during periods of great uncertainty on capital markets. In all these cases, private-sector investors value not only the soundness of multilateral institutions, but also their privileged relationships with governments. Such operations should be expanded further, on clear additionality criteria; in other words, the creation of support mechanisms that do not exist in the private market at a given moment. There is also the possibility of providing guarantees for bond issues by countries that have not previously made use of such financing mechanisms.

In view of the crucial role of domestic financial development, multilateral banks can also play a major role in the creation of financial markets in developing countries by supporting the restructuring of institutions guaranteeing adequate financial governance and modernization of domestic financial markets. Support should concentrate on creating national development banks and on their operations to provide funding for micro-enterprise and small and medium-sized businesses. Multilateral banks can also help create markets by issuing their own debt paper on developing-country markets, which serves basically to foster the development of long-term financial saving instruments.

Technical assistance, whether provided directly or linked to project funding, has been another characteristic of these institutions, in addition to their role in providing a meeting place for member countries for information exchange and analysis of successful and, equally importantly, failed development experiences. In close collaboration with United Nations agencies, they can also help ensure an adequate supply of certain global public goods in areas such as public health and the environment.

5. The role of regional institutions

As can be inferred from the preceding pages, Latin America and the Caribbean has a very comprehensive regional network of multilateral banks, probably the most complete in the developing world, consisting of the Inter-American Development Bank (IDB) and several subregional institutions. It can also claim several of the most advanced trade integration processes and one of the few regional mechanisms for balance-of-payments support in developing countries. Progress achieved on all these fronts needs to be consolidated, and new areas of cooperation added.

One of the most important of these is macroeconomic cooperation. Given the extreme sensitivity shown by intraregional trade, especially in South America, to business cycles and fluctuations in the exchange rates of national currencies (ECLAC, 2001d), closer coordination of

macroeconomic policies has become a key element in consolidating integration processes. The loss of autonomy that has occurred in these domains is another good reason to seek subregional and regional spaces in which such autonomy can be regained at least partially.

Progress has been made in this field in all subregional integration agreements.[24] These cover a wide range of increasingly deep processes: (i) dissemination of greater information on macroeconomic policies and personal knowledge of Ministry of Finance and Central Bank staff in the different countries; (ii) institutionalization of mechanisms for peer review of such policies, as a contribution to the preventive goals of global macroeconomic supervision and gradual internalization of the effects of local policies on neighbouring countries; (iii) definition of common macroeconomic targets and rules for fiscal and monetary policy, and for public and foreign borrowing; and (iv) possible establishment of solid macroeconomic coordination mechanisms, leading in the long run to the creation of monetary unions. Obviously, one should not be blind to the problems posed by the more advanced phases of this process, as revealed by the experience gained over three decades by the European countries. For this reason, objectives clearly need to be modest in the short term, focusing on the first three areas mentioned.

An initiative highly complementary to the above would be to establish mechanisms to coordinate policies for prudential regulation and supervision of financial systems. What is desirable in this area is the development of mechanisms for peer review of such policies, and possibly the design of more specific minimum standards than those of the Basel Committee. The fact that some of the main international banks operate in several countries of the region further underscores the importance of coordination in this field.

Several authors have also referred to the importance of having regional institutions capable of providing balance-of-payments financing, stressing their advantages over an international architecture consisting exclusively of a global fund (see Agosin, 2000; Mistry, 1999; ECLAC, 1999e). Institutions of this type can help modify financial agents' expectations and behaviour with respect to the region as a whole, thereby preventing contagion. Such a system would be able to channel resources to participating countries more rapidly, on better terms and in potentially larger volumes, thereby providing them with much stronger defences at times of crisis.

The Latin American Reserve Fund is one of the few institutions of this type in the developing world. In over 20 years' service, it has lent major sums to the five member countries of the Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela). For the smaller countries (Bolivia and Ecuador), it has been just as important as the International Monetary Fund.

At the international level, the most ambitious proposal of this type has been to create an Asian Monetary Fund —an idea that was studied at the initiative of Japan in the IMF meeting held in Hong Kong in 1997 (Hamada, 2000). This idea crystallized recently, albeit on a smaller scale, in the agreement signed by 13 Asian countries —the members of the Association of South-East Asian Nations (ASEAN), China, the Republic of Korea and Japan— in May 2000, to establish swap agreements between their respective central banks (Park and Wang, 2000).

A scheme of this type, either in the framework of the Latin American Reserve Fund or independently of the number of members and functions, could serve to considerably expand mechanisms for supporting countries in the region that face balance-of-payments crises. By way of

[24] The region's four integration schemes (CARICOM, the Central American Common Market, the Andean Community and MERCOSUR) have all made progress in agreements to define common macroeconomic targets on inflation, fiscal deficit, domestic and external public borrowing, the current account deficit and international reserves, among other issues. In each case the aim is to achieve greater macroeconomic stability, to strengthen capacity to cope with external crises and avoid damage to intraregional trade stemming either from sharp exchange-rate fluctuations or from deep recessions among the members of a subregional bloc. The earliest and most ambitious of these integration schemes is CARICOM, which has reached agreement to move towards tax harmonization, free circulation of persons, capital and services, and even monetary union. For a detailed analysis of the nature of these processes and the difficulties they face, see ECLAC (2002) with respect to CARICOM, see chapter 11 of this volume.

example, estimates by Agosin (2000) suggest that a regional fund consisting of just 15% of the international reserves of the South American countries could have financed all the external assistance channelled through these countries' emergency programmes in the last decade, except those corresponding to Argentina and Brazil.

Regional funds could be recognized by IMF as an integral part of a world system to support countries facing balance-of-payments crises. For this purpose, they could also be authorized to receive IMF loans quite automatically. Such funds could also be authorized to acquire special drawing rights denominated in their members' currencies, which they would then lend to countries in crisis.