No. 10 January 2004

RIS Policy Briefs

International Financial Architecture: An Agenda for Reform

The economies of developing countries have become highly vulnerable to speculative capital movements in and out of the country with the growing integration of financial markets. The recent economic crisis beginning with Mexico in 1994, East Asian crisis of 1997, the Russian crisis of 1998, the Brazilian crisis of 1999 and the Argentinian crisis of 2001 have highlighted the role played by speculative capital movements in triggering off the crisis situations. The frequency of crisis has sparked of a debate on the reform of international financial architecture.

Resource Flows to Developing Countries

Major changes have taken place in the international financial system in terms of changing magnitudes and composition of external resource flows to developing countries. Net long-term resource flows to developing countries have declined steadily since 1997. The official flows in particular have gradually dried up over the 1990s despite the rhetoric for reaching the 0.7 per cent target of official aid. Private flows now account for over 80 per cent of total long-term resources. While the private capital inflows such as FDI and portfolio investments have expanded in magnitude, they are determined by the levels of development and infrastructure among other factors. Hence, low income and least developed countries are unable to increase their share in private flows despite liberalization of policies. As a result the net resource flows to low income countries have reduced to less than half between 1996-2000 period.

Furthermore, the net transfers on debt to low income countries after providing for the debt service have turned negative since 1998 pushing them into a debt trap. The progress of HIPC (highly indebted poor countries) Initiative has been slow. The Monterrey High Level Conference on Financing and Development (FfD) has not been able to resolve the issue of the immediate need for restoring positive long-term resource flows to low-income countries. But for that achievement of the Millennium Development Goals would be a mirage.

An Agenda for Reform

In addition, the reform of international financial architecture should receive immediate attention if the re-occurrence of the economic crisis in different parts of the world which is not only painful for the affected countries but has contagion effects for other countries and is extremely costly for the international community, in terms of opportunity cost of hefty bail-out packages in terms of growth promotion and poverty elimination is to be checked. In particular, the reform of the international financial architecture that the developing countries could seek covers the followings:

a) Need for Restoring Long-term Resource Flows to Low-income Countries

While developing countries should look for all possible means to mobilize the domestic resources, the importance of external resources in supplementing the domestic resources cannot be minimized. However, as observed earlier, the transfer of official development resources to developing countries have declined sharply even in nominal terms. For instance, net long-term official resource flows to developing countries have steadily declined from $ 62.2 billion in 1991 to $36.5 billion in 2001. It has often been argued that since the private flows have been expanding at a dramatic pace, the declining levels of official resources would not affect the development process of developing countries in a significant manner. A particular reliance has been placed on FDI inflows, which have expanded considerably over the 1990s. Hence, developing countries have been advised by the Bretton Woods institutions to liberalize their policy framework to allow greater inflows of FDI, to take care of their resource requirements. Furthermore, it has been argued that FDI inflows are non-debt creating; they help host countries to integrate with the global economy, and bring technology and market access to their host countries.

Although private capital flows, including foreign direct and portfolio investments as well as bonds and

RIS Policy Briefs are prepared to communicate results of RIS research on specific policy issues to the policy makers.

This Policy Brief builds on a Chapter of *Globalization and the Non-Aligned Movement: An Economic Agenda for Action* (RIS, 2003).

RIS 20 Years (1984-2004)

bank borrowing, have expanded a great deal during the 1990s, they are no substitutes of declining levels of ODA. This is because the poorest, hence the most needy, countries are least likely to receive the private capital flows, as follows:

Foreign Direct Investment (FDI): FDI inflows are more stable, non-debt creating and also are prospective carriers of technology and other assets. However, as observed earlier, FDI inflows are strongly determined by the host country market size, income levels, levels of urbanization and the growth prospects. Hence, low-income agrarian countries are unlikely to receive substantial magnitudes of FDI inflows even with policy liberalization. Experience has shown that a bulk of the expansion of FDI inflows since 1990 has benefited a handful of middle income countries in Latin America, East Asia and Eastern and Central Europe. While the top ten recipients receive over three fourths of FDI inflows to the developing world, the poor countries in Sub-Saharan Africa and LICs receive a negligible (if at all) proportion of inflows despite liberalization of their FDI regimes. As observed above, the combined share of 48 least developed countries in FDI inflows has actually declined to a negligible 0.34 per cent in the 2000s.

Portfolio Equity Flows: Foreign portfolio equity flows could either take the form of equity investments in a receiving country's stock markets by foreign institutional investors (FIIs) like the pension funds, or GDR issues by domestic companies on the Western capital markets. An important prerequisite for FII investments to flow in is the existence of well-developed capital markets giving a good return. Most of the low-income countries have capital markets that are in their infancy, if they exist at all. Hence, the prospects of these inflows in providing considerable financing arise in only select emerging markets. Also these inflows are highly volatile in nature. GDR/ADR inflows can also be difficult to raise for enterprises based in low-income countries. The enterprises must, in the first place, be able to demonstrate their competitiveness, follow international norms of disclosure, and be in a position to bear substantial launching expenses before they can hope to raise resources at international equity markets. These factors act as formidable entry barriers. Although these inflows are more stable, very few low-income countries can tap these resources.

Bonds and Bank Loans: Bonds and bank loans are largely governed by the sovereign credit ratings of the concerned countries and are increasingly for shorter terms while being highly volatile in nature. The recent economic crisis has also exposed the weaknesses of the existing system of evaluating the credit rating of countries, which affect the movements of speculative capital to a considerable extent. At present, all the credit rating agencies, such as Moodys and Standard and Poor, are privately owned and controlled. The criteria followed by these agencies tend to be subjective and they overplay the problems faced by poorer countries. Poor credit ratings not only make it more difficult to borrow in the international markets, the terms at which the funds are available also become more onerous.

Therefore, expanding magnitudes of private capital and FDI, while a welcome development in itself, could not substitute for the falling levels of official development finance. Industrialized countries should offer assistance to developing countries with a renewed commitment to restore official development assistance in the spirit of global interdependence in the globalising world economy. In the interdependent global economy, any flow of resources to developing countries revert eventually in the form of enhanced imports by them. Implementing the UN target of ODA level at 0.7 per cent of their GDP, agreed to earlier, would lead to an additional flow of US$ 100 billion of resources to poorer countries at the present levels of GNP of industrialized countries. A flow of that amount of additional resources, if employed properly, could lead to additional growth stimulus not only in the developing world but in the world economy at large. Zedillo Report also supports the implementation of the 0.7 per cent target. In order to enhance the effectiveness of aid for promoting growth and poverty removal, ODA should be untied and be available to development policy making and implementing bodies so that it effectively supplements the domestic resources.

b) A Cautious Approach to Capital Account Convertibility

Capital market liberalizations in Latin America, Eastern Europe, and Asia have been followed by extreme macroeconomic crises. There is now almost a general consensus that developing countries should adopt a cautious approach towards liberalization of the capital account, keeping in mind the vulnerability that it brings with it. Prudent norms of behaviour and an effective mechanism for regulation of the banking and financial sector needs to be in place before the country could move towards liberalization of the capital account. There is no evidence that capital controls lower growth.

c) Transparency, Monitoring and Surveillance of International Borrowing and Lending

The East Asian crisis has been widely blamed on crony capitalism and, therefore, has highlighted the need for transparency, monitoring and surveillance of international borrowing by enterprises. However, prudential norms governing foreign lending are equally important. As Stiglitz has remarked, supposedly professionally managed banks lent to Korean corporations despite it being widely known that they were highly leveraged. Nor was there evidence of any pressure from the government on international banks that lent to real estate sector in Thailand. Long-Term Capital Management (LTCM) of the US had created an exposure of more than a trillion dollars before its crash, with a capital base of only about $ 5 billion.

d) Reform of IMF Conditionalities

The East Asian crisis has exposed the weaknesses in the IMF's package of conditionalities. These conditionalities do not take cognisance of the specific conditions existing in the affected country and prescribe the same set of conditions as if 'one size fits all'. They have been widely seen to compound the problem rather than resolving it. For instance, the IMF package uniformly insists on belt tightening and demand compression measures that affect growth adversely and hence make recovery even more difficult. Furthermore, despite a widespread recognition of the role played by the capital account liberalization in accentuating the crisis, the IMF has been pushing the affected Asian countries towards accelerated capital market liberalization in the wake of the crisis. Owing to the short sighted and rather inflexible approach to crisis management by IMF, Malaysia decided to withdraw from the IMF Programme soon after it was initiated to the programme after the crisis. Instead, Malaysia adopted an unorthodox approach to dealing with the crisis that included imposition of capital controls although temporarily and the adoption of a fixed exchange rate regime. More importantly, Malaysia's approach also included lower interest rates and fiscal expansion or pump priming by the government as against belt tightening measures and balancing of budget included in the IMF package. As a result, Malaysia did not suffer the kind of social consequences that other affected countries did and the recovery was rather quick with a 5.8 per cent growth of GDP in 1999 and 8.5 per cent in 2000, compared to much lower rates of growth achieved by Thailand, Indonesia and the Philippines under the IMF programme. There is, therefore, need for a thorough reform of the IMF's conditionalities and of bringing flexibility into the package that keeps in mind the specific needs of the affected countries.

e) International Regulation of Credit Rating Agencies

The movements of speculative capital are affected to a considerable extent by the credit ratings assigned to individual countries. As mentioned earlier, at present all the credit rating agencies such as Moodys and Standard and Poor are privately-owned and controlled. The criteria followed by these agencies tend to be subjective. The East Asian crisis has highlighted the inability of these rating agencies to objectively assess the economic situation in the affected countries. For instance, the credit ratings of the Southeast and East Asian (Indonesia, Korea, Malaysia and Thailand) countries in June 1997 were exactly the same as in June 1996. They were down-graded only after the crisis in these economies was in full swing. The Government of Thailand was able to borrow in the Euro-bond market at a spread of only 90 basis points over US Treasury Bills just a few months before the crisis erupted. These agencies thus failed to take note of the deteriorating liquidity position of these countries and thereby warn them to take corrective steps well in time. On the other hand, these credit rating agencies have over-reacted and have down-graded credit ratings of countries with sound fundamentals like India in the subsequent period.

There is a need for an international framework having *symmetric* representation of both lenders and borrowers for monitoring the credit ratings of countries. Further, a more continuous scale may be devised for the credit ratings of countries so that changes in these are gradual and not dramatic. This will allow the affected countries to take corrective measures before the situation gets out of control.

f) Curbing Speculative Capital Movements by Imposing a Tax

The excessive volatility of capital movements needs to be curbed. In this context, the international community should consider the imposition of an international tax of the type suggested first by economist James Tobin (hence called Tobin Tax). It could be imposed on short-term capital flows every time they cross the borders. Besides moderating the volatility of capital movements, such a tax could generate valuable resources to be channelled to developing countries as development assistance. For instance, it could go to a special fund meant for poverty alleviation. It has been estimated that given the levels of capital flows in the mid-1990s, a tax at the rate of 0.25 per cent could generate an annual revenue to the order of $ 300 billion, that is, twice as much as the total annual flows of FDI to developing countries and up to six times as much as the total annual ODA flows to them.

g) National Regulations on Short-term Capital Movements

A number of countries have imposed regulations to curb short-term capital movements with great success. For instance, Chile introduced restrictions on capital inflows in 1991 by imposing unremunerated reserve requirements. These reserves have to be maintained for one year irrespective of the maturity of the loan. Thus, they constitute an implicit tax on foreign borrowing that varies inversely with the holding period. The reserve requirements were extended to all types of foreign financial investments, including ADRs in 1995. Colombia also introduced similar reserve requirements in 1993, which were tightened subsequently to apply to all external borrowings with a maturity of less than five years.

h) Setting Up Regional Funds

The East Asian crisis has also highlighted the regional dimension of the contagion. Hence, there is need for greater regional cooperation in dealing with the crisis. Regional funds could be set up to assist developing countries in different regions for meeting their temporary liquidity problems and to help them avert default which may perpetuate the crisis by shaking the confidence in these economies.

There has been some progress in regional monetary and financial cooperation in Asia since the crisis of 1997. The Japanese government had proposed to set up an Asian Monetary Fund (AMF) first in 1997. There is merit in this proposal. AMF could monitor the region's economies and provide early warning to the respective governments on the impending crisis. It could also provide speedy assistance to deal with the crises in their early stages so as to prevent them from spreading. AMF could also be a significant step towards decentralisation of international monetary and financial decision making that is currently concentrated in Washington DC. However, despite strong support within the region, the proposal for an AMF did not get far. It was opposed by the United States and IMF, as it posed a serious threat to IMF domination. Thus, Japan retreated at a meeting in Manila in November 1997. The AMF proposal was rejected in favour of a US-backed 'Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability', popularly called the Manila Framework. In 1998, Japan proposed the Miyazawa Plan at the Annual IMF-World Bank meeting, which is a more modest proposal. It sought to provide a $ 30 billion package for the region for short-term trade financing as well as recovery through long-term projects. It was suggested that the Japan Export-Import Bank, the World Bank and the Asian Development Bank could jointly take part in the initiative. As a part of this initiative, Japan established short-term swap arrangements with South Korea ($5.0 billion) and Malaysia ($2.5 billion).

Despite the US resistance to the AMF idea, a programme of monetary cooperation in Asia is slowly taking shape. Under the Chiang Mai Initiative launched in May 2000, a currency swap plan is being established between 10 member states of ASEAN and Japan, China and South Korea linking the international reserves of these countries. It covers a series of bilateral swap arrangements that would allow participating countries to draw automatically on 10 per cent of available capital without triggering any linkage to conditions imposed by IMF programmes. The ASEAN Plus Three Swap Arrangement was concluded at the annual meetings of the ADB in Honolulu in May 2001. This represents a substantial progress towards the eventual goal of setting up the AMF in Asia. It should be expanded to include some of the South Asian economies, which would give it a truly Asian character. There is an urgent need to visualise such efforts for other regions also.

i) Revival of SDRs Allocation

Special Drawing Rights (SDRs) were established by the IMF at the end of the 1960s to supplement international liquidity. SDRs were supposed to become the principle reserve asset. However, the allocation of SDRs has been abruptly halted since 1981, thus adversely affecting the ability of developing countries to supplement their reserves and making them vulnerable to the liquidity crisis. They have been forced to borrow on onerous terms to augment their international reserves. The institution of SDRs continues to be relevant, especially for developing countries and it should be restored as soon as possible by the IMF.

j) Appropriate Exchange Rate Regimes

Freely floating exchange rate policy can promote market discipline but brings in volatility in the short-term. Fixed exchange rates, on the other hand, take away the monetary autonomy. Therefore, a managed float exchange rate policy with sufficient flexibility at the same time can help avoid a serious exchange rate misalignment caused by persistent capital movements. This is widely perceived as the most appropriate for Asian countries with substantially liberalized capital accounts.

RIS Policy Briefs

- #1 **Relevance of an Asian Economic Community**
- #2 **Initiative for Closer Economic Cooperation with Neighbouring Countries in South Asia**
- #3 **Reserve Bank of Asia: Institutional Framework for Regional Monetary and Financial Cooperation**
- #4 **Cancun Agenda: Trade and Investment The Way Forward for Developing Countries**
- #5 **Cancun Agenda: Environmental Requirements and Developing Countries Exports – Lessons for National, International and Regional Action**
- #6 **Cancun Agenda: TRIPs and Development Implications and an Agenda for Action**
- #7 **Cancun Agenda: Geographical Indications and Developing Countries**
- #8 **Energy Cooperation in South Asia: Potential and Prospects**
- #9 **Road to a Single Currency for South Asia**

RIS Discussion Papers, *Policy Briefs* and *RIS Diary* are available at RIS Website: www.ris.org.in

RIS
Research and Information System for the Non-Aligned and Other Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: dgoffice@ris.org.in
Website: http://www.ris.org.in