EGDI
Studies in brief
4|99

The Poorest Countries and the Emerging International Financial Architecture

Stephany Griffith-Jones and José Antonio Ocampo
with Jacques Cailloux

Due to their limited integration with international capital markets, low-income countries have mostly been relatively little affected by the Asian crisis. However, a complete assessment of the impact of the crisis is still premature, since further adverse effects on the terms of trade of some of the poorest countries may be expected. There is a need to reverse declining public flows, to increase low-income countries' access to private flows, and to significantly reduce highly indebted poor countries' (HIPC) debt. In current discussions of a new financial architecture there is, however, a gap as these and other issues of importance to the poorest countries have not been included. This study focuses on issues of international measures to prevent and better manage crises and discusses their relevance for the poorest countries.

Pattern of capital flows

Private capital flows have tended to concentrate in middle-income countries. The share of private flows to low-income countries is clearly lower than the low-income countries' share of all developing countries' GDP. Although this is problematic in many respects, it has implied that the low-income countries have suffered less directly from issues of capital flow volatility and contagion in recent crises.

As regards public flows, low-income countries are - naturally - the major recipients of official development assistance (ODA), particularly grants, which are given mainly bilaterally. Of World Bank and IDA lending, a fairly high proportion has also gone to low-income countries. However, the declining level of World Bank lending in the 1990s (and especially in the 1995-97 period) has implied declines in loans to low-income countries.

IMF lending has been very anti-cyclical (in relation to private flows) and has increasingly concentrated on a few large borrowers: the countries suffering major currency crises. Large IMF lending substitutes for private financing when it collapses or reverses. This has implied a concentration of official liquidity financing in middle-income countries. If a new financial architecture is

EGDI Studies in Brief summarise recently published EGDI studies. The responsibility for the summary is with the EGDI secretariat.

implemented, and if it is effective in reducing or significantly moderating currency crises, then this somewhat perverse pattern of flows can be reversed, and more attention devoted to the needs of low-income countries.

The call for a new international financial architecture

In the short-term, there is an urgent need to reverse declines of ODA to low-income countries, to accelerate again multilateral lending to them, facilitate their access to the more stable forms of private flows (especially foreign direct investments, FDI), as well as significantly reduce HIPC debt. More broadly, there is a clear gap in current discussions of a new financial architecture in that these - and other - crucial issues of development finance, of particular significance to low-income countries, have not been included. Other issues include improving the access by low-income countries to private finance, via mechanisms such as guarantees.

These issues must be directly integrated into the current discussion of a new financial architecture. This implies that separate, but linked, studies, task forces etc. are organised (with large participation from the low-income countries, but also from Bretton Woods institutions, donor governments and the UN) on the major issues of development finance. The result of these studies and task forces would then be integrated into a broader international financial architecture, which would facilitate appropriate flows (both in terms of scale and stability), to both middle- and low-income countries. A positive feature is that a fairly significant proportion of the proposals on the table from spring 1998, have either been seriously studied or actually began to be implemented. This is particularly true for those proposals that do not require significant institutional innovation.

The Financial Stability Forum

Amongst the most positive steps is the creation of the Financial Stability Forum (FSF), the creation of new facilities of the IMF (including most recently and significantly the Credit Contingency Line, the CCL), as well as improvements in information, particularly on developing countries. However, the ways in which each of these has been implemented have serious limitations. Furthermore, in the area of internationally sanctioned standstill arrangements and the required amendment of bond clauses, little actual action has taken place, though the discussion has become increasingly more specific and certain consensus seems to be broadly emerging.

The rapid initiation of the FSF is an important step forward in the global regulation of private flows. However, the current lack of participation of developing countries in the decision-making FSF is a serious limitation, even though these countries do participate in the Working Groups, where important work is beginning. Participation of developing countries, including low-income ones, in the FSF is urgent, as they are the main victims of the volatility that the FSF is attempting to stem. Secondly, the FSF may need to be strengthened in its decision-making power, as its purely co-ordinating and consensus-seeking role may not be sufficiently strong in the future.

Thirdly, it is unfortunate that certain regulatory changes have taken so long to be made. An example is the modification on capital adequacy rules to reduce regulatory incentives for short-term bank lending to developing countries, on which very broad consensus has been reached. Fourthly, the initial priority areas of work (highly leveraged institutions, offshore centres and curbing volatility of short-term flows) are extremely important; however, other areas - such as evaluating prudential regulation of other institutional investors, for example mutual funds, could be usefully added.

The Credit Contingency Line

The creation of the CCL is also potentially an important step forward to limit contagion, by encouraging countries to adopt policies that will discourage crises and by signalling to the markets that this facility is available. Both may help to avoid crises.

However, there are several concerns regarding the way the CCL is being structured. Firstly, would the scale be sufficient to stem a crisis? Would low-income countries also receive CCL support if they were hit by a contagion-caused crisis? Secondly, why is disbursement - in the stage of crisis threat - not automatic, for countries that have pre-qualified? Thirdly, why is the CCL not open to countries with current or expected regular IMF financing? Fourthly, will conditions be too restrictive, and thus make countries unwilling to negotiate CCL? Careful monitoring of the evolution of the CCL and its use is required, as well as continuous analysis on the complex issue of how official liquidity best can be used in emergency financing.

Improved transparency and information

Much useful progress has also been made on improving information on developing countries, which hopefully will help markets and policy-makers take better decisions. However, the possibilities and benefits of improved information have very important limits, both due to asymmetries of information and because of the significance of how information is processed. Furthermore, more limited progress has till now been made on the equally important issue of improving information on international financial markets. The latter is extremely important, and further initiatives need to be taken by the Bank for International Settlements (BIS) and the FSF. Low-income countries should have easy access to this new information on international capital markets.

Much emphasis has also been placed on the development of numerous standards, and their implementation by developing countries. A source of concern is that developing countries - especially low-income ones - do not on the whole participate much in the definition of those standards, though they are being asked to implement them. Both meeting standards and enhancing information put an important burden on developing countries, especially low-income ones. As a consequence, technical assistance in this field, especially to the poorer countries, is a priority.

Private sector involvement in resolving and preventing crises

On the issue of emergency measures involving the private sector during crises, some limited progress has been made, especially as regards broadening the power of IMF lending into arrears and the arrangement of concerted roll-over of credit for Brazil and Korea. However, the larger issues have not yet been tackled, both because of their complexity and because of different interests and perspectives involved. Concrete progress needs to be made on orderly debt work-outs, including particularly changes in bond covenants; interestingly UK-issued bonds already have more flexible clauses, and these do not as yet carry higher spreads; this provides a very important precedent for modifying clauses in US and German bonds. It is important that changes in these clauses are introduced both by developed and developing country borrowers, to avoid stigmatising and marginalising developing country borrowers.

In particular, modifying bond contracts should not be imposed by IMF conditionality on developing country debtors, as has been suggested. Developing countries need to have the freedom to decide whether they want to modify them, assessing carefully costs and benefits of such a measure. The costs include possible reduction in access to bond markets and possible increases in spreads, whereas the benefits include greater flexibility and better burden-sharing in times of crises. As regards internationally sanctioned standstills, even less progress has been made, though a number of interesting proposal have emerged on mechanisms, modalities and institutional arrangements.

Adequate regulation and macro-economic policies

There is still much to do on financial architecture. This is particularly so because recent crises have had an unacceptably high cost in terms of interrupting and - sometimes - reversing growth and development, increasing poverty, and discouraging future private investment, both by national and foreign investors. These currency crises also distract the international official community from the crucial task of increasing and improving official flows to low-income countries, which need to play a continued role in helping their growth and in supporting poverty alleviation in them.

Though the report focuses more on issues of international measures to prevent and better manage crises, clearly these need to be complemented by national measures, both in the prudential and capital account regulatory areas and in macro-economic policy. These measures include prudent regulation of domestic financial systems. Moreover, adequate regulation and control of capital flows are also ingredients. These measures are important for low-income countries, even though they do not receive very large private flows. Indeed, even relatively small private volatile flows could destabilise small, low-income countries (with disastrous effects on poverty). Learning to manage sharp financial cycles with adequate policies is a slow process that needs accumulation of experience since the early stages of development, to avoid costly mistakes later on. Prudence in the liberalisation of certain categories of capital flows (the more volatile ones) to avoid excessive surges of such flows may be an important area, where low-income countries may benefit from being late-comers to the game This should help minimise low-income countries' vulnerability to currency crises, which would be particularly costly for them as so many of their people are so close to the poverty line.

More generally, the traditional emphasis on crisis management needs to be changed to the management of booms, since it is in the periods of euphoria from capital inflows and terms of trade improvement that crises are incubated. This implies introducing stronger counter-cyclical elements in the following areas:

(1) Macro-economic policy, by fiscal targeting of the sustainability of public sector debt ratios throughout the cycle. This will imply fiscal tightening in the upswing and some loosening in the downswing. Anti-cyclical fiscal devises can include fiscal stabilisation funds based on temporary public sector revenues, to be saved during booms and well-designed social safety nets that would be particularly valuable in times of crises. This would reduce spending during the boom and increase it during crises.

(2) Strengthening as well as increasing counter-cyclical elements of financial regulation and supervision, to prevent excessive risk taking. Indeed, prudential regulation must take into account not only the micro- but also the macro-economic risks typical for developing countries in an increasingly globalised and volatile world. Firm as well as total debt exposures need to be carefully monitored, as well as their profiles, to prevent vulnerability to crises.

(3) If excessive short-term, potentially reversible, capital flows enter the economy, measures - such as Chilean style or Colombian style reserve requirements - clearly need to be taken. Furthermore, a permanent system of reasonable capital account regulations, which is strengthened or loosened throughout the cycle, is preferable to free capital movements during booms and quantitative controls during crises. This is especially so, since the latter may be ineffective or counter productive, and will lack adequate institutional backing.

There is one area of macro-economic policy, both in developing countries in general and for low-income countries, where further research is urgently required. This is the area of the appropriate exchange rate policy for small, increasingly open economies in a world of large global capital flows. These flows provide new sources of volatility to developing countries, and may further magnify the traditional source of volatility, i.e. terms of trade shocks.

The Expert Group on Development Issues, EGDI, was established by the Swedish Government in 1995 with the objective of contributing to an increased understanding of development issues in a global context and increasing the effectiveness of development cooperation policies.

The task of the EGDI is to initiate studies that will have the potential to make contributions to development thinking and policy-making. In order to ensure a close relationship with research and policy communities around the world, internationally renowned specialists with extensive networks in their respective field work as members of the Expert Group.

A secretariat assists the group and a number of reference groups have direct contact with the work in progress. An annual budget is determined by the Swedish Government.

The full study (EGDI Study 1999:4) can be ordered from
Almqvist & Wiksell International
P.O. Box 7634
SE-106 94 Stockholm
Sweden
Telefax:+46 8 24 25 43
order@awi.akademibokhandeln.se

Ministry for Foreign Affairs
EGDI Secretariat
Department for International Development Cooperation
SE-103 39 Stockholm
Sweden
Telephone: +46 8 405 10 00
Fax: +46 8 723 11 76
ulrica.risso-engblom@foreign.ministry.se

EGDI
Expert Group on Development Issues