

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE: CONSENSUS AND DIVERGENCE

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The Asian crisis and its rapid spread to Russia and Latin America in 1997 and 1998 gave rise to a broad consensus on the need to reform the international financial architecture in order to reduce the inherent instability of the current system. The recovery of the economies affected and the tendency for financial markets to normalize have reduced the sense of urgency in these reforms; but this could also be seen as an opportunity to set in motion a balanced, representative process for strengthening international financial governance. This chapter critically reviews the ongoing debate from the developing country perspective and argues the case for a thoroughgoing reform of the current architecture. Section 1 takes a brief look at four basic propositions that must underlie any relevant reform in this area. This serves as the basis for a closer look, in sections 2 and 3, at the current controversy which is organized in terms of the distinguishing areas in which there is some agreement from those in which there is still a considerable divergence of opinion. This is an expository device, based on the author's personal perception of existing consensus and divergence. As we will see, however, even in areas where some agreement is said to exist, there are considerable differences in the interpretation or in the relative emphasis given to each specific component of the reform. The chapter focuses on reforms

needed to prevent and manage financial crises—what may be called the 'narrow' financial architecture—leaving aside issues relating to development finance, in particular.¹ Section 4 draws some conclusions from the analysis.

1. FOUR ESSENTIAL PROPOSITIONS FOR A RELEVANT REFORM

Any meaningful reform of the international financial architecture must be based on four basic propositions. The first one is that the instability of the system reflects 'information problems' that are largely unsolvable, as financial market behaviour is determined as much by *opinions* and *expectations* as by information, in the precise meaning of that term (i.e., factual information).

The central role that imperfect information plays in generating market failures in the financial sector is well known.² Improved information is thus central to a better market performance. However, we have seen in recent years how sophisticated and increasingly informed financial markets have continued to be extremely volatile. There are many reasons for that. The most important is probably the fact that much of the relevant information to which the market reacts comes only with a significant lag, and depends on macroeconomic conditions that are not entirely known in advance. Thus, for example, some investment decisions made before the Latin American debt crisis of the 1980s or before the 1997 Asian crisis may have been unsound to start with, but the magnitudes of the losses associated with them were determined even more by the major macroeconomic shocks that these regions experienced, which were probably unpredictable—certainly with respect to their magnitude—and were indeed unpredicted by even the best observers. The

increasing information that is relevant for improving microeconomic efficiency may, thus, do very little to reduce *macroeconomic* volatility.

The economic factors that determine such macroeconomic volatility are, thus, central to financial market performance. We should mention first in this regard, using Joan Robinson's terms, that 'historical time' involves *uncertainty*. Thus, the investment and savings decisions that determine macroeconomic behaviour and performance are based on opinions and expectations on the uncertain evolution of economic variables rather than on risk probability distributions that can be known *ex-ante*. In a word, markets are necessarily imperfect when time is involved, as the information necessary to correct such 'market imperfection' will never be available.

The way information is processed to form such opinions and expectations poses additional problems. A fundamental microeconomic factor in this regard is the fact that processing of information for individual decisions is subject to sharply increasing marginal costs, particularly when it involves financial actors that constitute complex decisions. Thus, a board of directors of a financial institution faced with a decision to invest in a particular country (or sector), or even whether to invest at all, will not be able to take into account the rich information that the direct market operators of that institution may have on the strengths and weaknesses of all specific firms in that country (or sector). Much simpler information and even rules of thumb would be necessarily used, and the tendency to conform to the 'average opinion' that may exist in the market at that time would be very strong.³ Regardless of the rationality involved in forming such an 'average opinion' (or the lack of it), it is clear that the changes that it may experience will have major effects on markets. Indeed, the interrelation of the 'information' that financial actors manage at any

particular time—i.e., the 'information cascades'—or, rather, interrelation of the opinions and expectations that is formed from such information, is central to the rich contemporary literature on self-fulfilling booms and busts.

Changes in opinions through time indicate that the *same* information may be interpreted in a totally different way at different times. Moreover, the mix between the simple way opinions and expectations are formed with today's sophisticated markets implies that markets may actually become *more* volatile in the face of changed expectations. This is the opinion of the chairman of the Federal Reserve Board, who has argued that the 'size of the breakdowns and required official finance to counter them is of a different order of magnitude than in the past' (Greenspan 1998). Indeed, certain characteristics of sophisticated markets may enhance instability. This is, first of all, an effect of improved communications and 24-hour trading around the world. Specialized information in today's markets may have the same result. In the case of emerging markets, for example, there is strong evidence that grading agencies may have increased rather than reduced volatility (Larraín, Reisen and von Maltzan 1997). Also, changes in the opinions of those investors who are considered to be 'informed' may lead to overreactions by non-informed ones, who rely on the former to make their decisions (Calvo 1998). It is also generally accepted that the unbundling of risks through derivative operations and the corresponding concentration of certain risks in specific agents imply that even if improved regulation and supervision of these operations were designed, a breakdown in that corner of the market would have amplified implications.

The second proposition is that, as in any other case, self-insurance is a costly option in the area of international finance. This sounds self-evident and should probably be left aside

from the discussion altogether, were it not for the fact that many proposals, particularly those involving developing countries, imply that in the current order, a degree of self-insurance is inevitable. Indeed, the line that divides national policies aimed at preventing crises from self-insurance is a fuzzy one. Thus, high levels of international reserves, building stronger credibility through the introduction of deflationary biases in macroeconomic policy, the adoption of prudential regulations stronger than those recommended by the Basle Committee, and discouraging excessive short-term external borrowing through price-based or quantitative capital controls, i.e., the whole array of national policies recommended to developing countries in a world of volatile capital flows (with the particular preference depending on the author), all have elements of self-insurance attached to them.

All these exclusively national options are costly. Thus, although the prevention of excessive risks is an essential element in the design of any insurance system, the basic architecture of the international financial system cannot rely solely or even fundamentally on strengthening these forms of 'self-insurance'. Rather, it should aim at devising at the international level appropriate institutional mechanisms that reduce the costs involved in relying exclusively on national policies, and in choosing the less costly among them. In the case of developing countries, the greater volatility associated with capital flows and/or terms of trade fluctuations implies that exclusive reliance on a high level of international reserves or deflationary policies to manage downside macroeconomic risks may be very costly. Stringent domestic regulations to manage financial risks may be necessary, but they are also costly. Thus, a well-designed international system must complement those policies with institutional mechanisms that allow these costs to be minimized. We will argue below that, from the perspective of national policies, the advantages of discouraging

short-term external borrowing lie precisely in the fact that it reduces (though it certainly does not eliminate) the need to rely on other, more costly alternatives.

The third proposition that is essential to the analysis of international financial reform is the recognition that nations, particularly the industrialized countries but also many developing countries, are willing to give up their economic sovereignty only very partially, if at all—or, in the case of countries in the European Union, only to a regional organization. The positive and negative sides of this fact can be extensively argued over, but any viable reform must take it into account. This indicates that the 'financial safety nets' that have been developed at the national level to manage market instability cannot be replicated in the international system, or can be copied only in a partial and imperfect way. This is true of central banks, prudential regulation and supervision, deposit and credit insurance and guarantees, and bankruptcy procedures. This implies, in turn, that an essential task in the design of the international financial architecture is to guarantee that a system which will continue to rely essentially on a network of *national* institutions (regional in the case of some EU ones) takes adequate account of their international linkages. It also implies that options that are closed at the national level (such as strong restrictions on certain market activities, or even unilateral standstills on debts) should probably be left as open options at the international level.

The fourth proposition is that no international financial design is neutral in terms of the equilibrium in international relations. Thus, the particular balance that each alternative involves, as well as the *procedures* by which reforms are discussed and decided upon, should be a central concern for developing and small countries (UN Task Force 1999; Group of 24, 1988; Helleiner and Oyejide 1998). It will be strongly argued in this chapter

that an international system that relies on one or a few international institutions is less neutral than one that relies on a network of regional institutions and on peer review among national institutions. More democratic forums are superior to closed ones, in terms of generating stable consensus by all players, powerful or not. A broad agenda, in which all relevant issues are placed on the table, is also preferable to a limited one. Given its unique character as a global forum, certainly the most democratic of its kind, the United Nations should play a role in this area, through an improved Economic and Social Council or the Economic Security Council recommended by the 1995 Commission on Global Governance, the mandates of which would obviously cover a broader set of economic, social and environmental issues. Finally, but no less important, a country with very limited power in the international arena will be better off if it has access to a broader menu of alternatives to manage a potential crisis than if it is restricted to a few options.

The combination of these four propositions is what makes the desired system, and the routes to it, so complex. It will be argued here that only an integral system, which includes all the areas considered in this chapter, is desirable. In a sense, the desired system is complex largely because it includes many 'second best' or even 'n-best' components, as no single, optimal solution is available. Moreover, even if an agreement were reached to replicate national financial institutions at the international level, it is unclear whether that system would be desirable to smaller international players, given the nature of world relations. The route is also made more complex by the fact that some major players do not perceive themselves to be facing fundamental problems, and by the additional fact that the simpler decision-making system that characterized the design of the Bretton Woods system in which the two dominant powers negotiated between themselves, would be unacceptable today. We should probably add that this is also the reason why some

perceive that only a limited reform is viable, and why viable alternatives should build on existing institutions rather than relying on the creation of new ones.

2. AREAS OF GROWING CONSENSUS

2.1. The need for expansionary policies in industrialized countries during crises and for emergency financing for countries in difficulties

A clear consensus has been building up in some areas, though in most cases it is accompanied by significant differences in interpretation or in the emphasis given to each specific component of the reform. There is, first of all, a consensus that an international financial crisis requires expansionary policies in the industrialized world. This is an essential difference between the recent crisis (as well as the 'tequila' episode of 1994) and the Latin American debt crisis of the early 1980s, when high interest rates induced by contractionary monetary policies in the United States clearly increased the severity of the contraction (Díaz-Alejandro 1988: ch. 15). Curiously, the shift towards this recent consensus has been building up only since mid-1998 and, despite the incomplete normalization of capital flows to emerging markets, it was replaced by a new shift in the stance of monetary policies in the United States and the European Union in mid-1999. This incomplete normalization reflects the limited 'trickling down' of the expansionary policies of industrialized countries, i.e., its limited (or lagged) effects in terms of restoring confidence in emerging markets during crises.

The limited 'trickling down', as well as the strong evidence of contagion, is the basic reason for the growing consensus on the need to increase the supply of emergency financing in times of crisis that is made available *before*—rather than after—international reserves are depleted. Moreover, such financing should include countries facing contagion, as was recognized with the creation of the Contingency Credit Line created in April 1999, though under very restrictive eligibility criteria. These principles of intervention are a major advance, not only with respect to those adopted in Bretton Woods, based on the concept of a 'fundamental disequilibrium' in the balance of payments, but also with respect to experience accumulated since the 1994 Mexican and the 1997 Asian crises, when emergency funds were approved only after the crisis had been unleashed. Still, the effectiveness of the new type of contingency financing may be limited, for several reasons: (i) because it may serve to postpone the adjustment considered inevitable; (ii) because the negotiation process is too cumbersome; and, probably more importantly, (iii) because the market judges that the intervening authorities (the IMF, supported by some development banks and a few industrialized countries) are unable or unwilling to supply funds in the quantities required to stabilize speculative pressures. These difficulties are compounded by controversies over the nature of conditionality involved in the use of funds and moral hazard issues on the side of private lenders. We will return to these controversies below.

2.2. The need to improve the institutional framework in which financial markets operate

A third area of consensus relates to the need to improve the information provided to financial markets, to adopt common minimum standards in prudential regulation,

supervision and financial accounting, codes of conduct in fiscal, monetary and financial policies, and principles of sound corporate governance, i.e., to improve the institutional framework in which financial markets operate. There is, in particular, a broad agreement on the important role that information plays for adequate microeconomic performance in financial markets, and on the need for strong regulation and supervision to guarantee financial stability.⁴ Disagreement remains, however, on what authorities would be given broader responsibilities in the area of prudential regulation and supervision, on what types of additional regulation would be required to reduce volatility and on how much additional information, regulation and supervision would contribute to stability.

On the first of these topics, bolder reform recommendations include the proposal to create a World Financial Authority responsible for regulatory practices and effective risk management procedures, overseeing the development of credible guarantor and lender-of-last-resort functions and the accountability of the IMF and the World Bank (Eatwell and Taylor 2000). Less ambitious suggestions are based on strengthening the BIS (Basle Committee) and IOSCO activities in the areas of domestic regulation and supervision, which would require extended membership by developing countries in these organizations. Peer review can also be used more extensively in this area.

There is now a broad agreement, which includes the authorities in developed countries, to extend prudential regulation and supervision to high leveraged institutions and offshore centres. But clearly reforms should go beyond that. In the case of industrialized countries, prudential regulation of financial institutions, including mutual and hedge funds, should clearly give greater weight to the high risk associated with operations in countries incurring large net borrowing, particularly of a short-term character—indeed, reforming

the bias towards short-term lending implicit in current Basle standards. This would discourage this type of lending at the source. On the borrowing side, international standards and the corresponding domestic regulation should include or give greater weight to risks related to the accumulation of short-term liabilities in foreign currencies (Furman and Stiglitz 1998; Rodrik and Velasco 1999), to the growth of credit, to currency mismatches of assets and liabilities, and to the valuation of fixed assets as collateral during episodes of asset inflation. Depending on the operation, higher capital standards, matching liquidity requirements or caps on valuation of assets should be established (UN Task Force 1999; ECLAC 1998b).

Also, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. This indicates that prudential regulations should be stricter in developing countries, where such links are more important, and that they should be strengthened in periods of financial euphoria to take into account the increasing risks which financial agents are incurring. Indeed, otherwise the application of strict prudential regulations may become a pro-cyclical element of economic policy since their effect is more stringent during a downswing, when provisioning standards and their effects on capital requirements affect the capacity to extend credit. Moreover, due to the important externalities which large non-financial firms could generate on the domestic financial sector, particularly in the context of an exchange rate depreciation, the unhedged external liability exposures of these firms should also be subject to regulation (UN Task Force 1999; ECLAC 1998b).

The information problems which regulation and supervision face should not be underestimated, however (UNCTAD 1998: Part I/ch. 4). Regulation will almost

necessarily lag behind financial innovations, and indeed regulations will induce innovations. Moreover, since regulation always focuses on the activities of specific intermediaries rather than on financial services as such, an important form of innovation is the creation of new, unregulated agents that provide the same services. Supervisors can only review a limited number of individual operations by financial intermediaries, and that information will necessarily be partial and be available with a lag. Indeed, the experience of supervision worldwide indicates that many high risks are really known by the authorities only when it is too late to avoid some (even large) insolvencies from occurring. Moreover, this information comes as a significant surprise even to the (profit-motivated) financial and non-financial private firms involved, a fact which places significant doubts on whether the decisions that underlie such high risks could have been avoided in the first place. This is largely associated with the fact that unprofitable and loss-making investment decisions (and, thus, their real riskiness) are known only years after they have been made and, as we have pointed out, depend on macroeconomic as well as microeconomic factors, many of which are only known (and can only be known) *ex post*.

On the other hand, although an essential role of prudential regulation and supervision is to make financial intermediaries more risk-conscious, there are clear limits to the appropriateness of discouraging private risk undertaking. After all, this is the basic role of private entrepreneurship, and an essential role of financial systems is to facilitate the undertaking of risky ventures. Some classic roles of regulation may also become useless under major macroeconomic shocks: diversification of risks at the national level may turn out to be an inadequate safeguard under these conditions, attempts to avoid this problem by diversifying into assets and liabilities in foreign currencies generate new risks associated to currency mismatches, and capital requirements necessary to avoid some

(hopefully) unusual circumstances may be so high as to entirely discourage important financial services.

Moreover, though prudential regulation is an essential activity, it involves some price signals (e.g., higher capital requirements as a counterpart to riskier assets, and higher liquidity requirements for short-term liabilities), but also a whole array of quantitative restrictions (e.g., outright prohibitions, or explicit limits on certain types of operations, such as matching requirements between certain assets and liabilities and limits on credits to related parties). On the other hand, prudential supervision is necessarily a discretionary public sector intervention. Thus, it involves two forms of intervention that are generally viewed today as subject to important 'government failures'. Indeed, a peculiar paradox in the recent literature is that authors, who are unwilling to accept that quantitative restrictions and discretionary government intervention and even public sector intervention at all are good in other areas of economic policy (e.g., trade policy or capital account regulations), are fervent in the defence of quantitative controls and discretionary policies in this particular case.

Although the argument in favour of stricter prudential regulation and supervision is a compelling one, there are thus limits to what these instruments can achieve in terms of avoiding financial crises, and there are also costs to stricter regulation that cannot be ignored. The lags in regulatory practices and the limits to what supervisors can do, on the other hand, are strong arguments to emphasize the *internal* regulation system that banks and other financial intermediaries develop, and to focus an important part of supervisory activities on analysing the functioning of such internal regulations.

Similar comments can be made about information. As we have argued, improved information may enhance microeconomic efficiency but may not improve macroeconomic stability, which is dominated by the evolution of opinions and expectations rather than information, in the correct sense of that term. During periods of financial euphoria, enhanced information has been unable to avoid excessive risk-taking in developed and developing countries alike. On the other hand, in today's informed but volatile markets, market discipline may generate a strong deflationary bias in macroeconomic policy during crises, and thus a more procyclical performance of economic activity, as authorities try to build credibility (Eatwell 1996). Under these conditions, stronger mechanisms for the authorities to 'lean against the wind' in times of financial euphoria may be necessary, as well as alternatives to manage the crisis—in particular, regulation of capital flows and standstill provisions, respectively.

2.3. Consistency, surveillance and consultation of national macroeconomic policies

Given that economic sovereignty would be given away only in a very partial way, stronger mechanisms to guarantee that the externalities generated by macroeconomic policies events are adequately dealt with are necessary. In the case of industrialized countries, this is essential to guarantee the global consistency of their macroeconomic policies, i.e., their collective ability to avoid both world inflationary and deflationary pressures. In the case of developing countries, evidence of contagion calls for similar mechanisms to develop collective lines of defence in the face of financial boom-bust cycles and to internalize at least partially the regional effects of macroeconomic policies.

The three essential problems are the weaknesses of the current arrangements, lack of adequate representation of the developing countries, and the considerable asymmetry between the two phases of the business cycle. With respect to the first of these problems, the Group of Seven is a weak mechanism of consultation; IMF Article IV reviews can be ignored rather easily by countries which do not require Fund financing, and there are no mechanisms of consultation (less so of surveillance or coordination) at the regional level in the developing world. In relation to the second problem, developing countries and the smaller industrialized countries obviously have no voice in the Group of Seven, and their representation on the IMF Interim Committee is less than desirable. The asymmetry between the two faces of the business cycle is reflected in the fact that, whereas the combination of market discipline and IMF conditionality is a very strong mechanism in the downswing, there are no similar mechanisms in the upswing when most of the risks that are later reflected in the crisis, incur. In a word, crisis prevention is essentially the role of policies adopted to manage booms, when 'market discipline' is perverse, as it rather encourages 'irrational exuberance' (to use Alan Greenspan's term), and there are no constraints on the adoption of national procyclical policies.

Thus, although stronger organs are required to guarantee the global consistency of macroeconomic policies, their creation should be accompanied by an improved representation of the developing countries in the corresponding institutions. This should go together with a strong emphasis of the critical role that Article IV consultations and parallel regional mechanisms should play in this area. It is also crucial that all these surveillance and consultative mechanisms give greater weight to the management of booms, when financial crises are incubated.

2.4. Internationally sanctioned standstill provisions to guarantee an adequate sharing of the burdens of adjustment

Through its chaotic effects on exchange and interest rates and on domestic economic activity, disorderly capital flight generates significant damage for debtor countries, and considerably increases the probability that illiquidity may turn into insolvency. It is also bad for creditors, as it reduces the probability that many of them will be repaid. Under these conditions, the unilateral suspension of debt servicing also generates significant damage. It destroys the credibility of national authorities and thus may worsen, rather than improve, conditions in the short term. The experience of many developing countries indicates that it leads to a repeated exercise of debt rescheduling, which interrupts investment and growth for protracted periods. On the other hand, under these conditions, the provision of emergency financing by international institutions and official sources may serve to bail out many private creditors, raising moral hazard issues and serious concerns over the distribution of the burden of adjustment.

These considerations are the basis for the growing consensus on the need to create internationally sanctioned standstill provisions (also referred to as orderly debt workouts) in the area of international finance. These provisions would play the same role as national bankruptcy procedures play in domestic affairs. The preventive suspensions of debt service and agreed rescheduling under an internationally agreed procedure would serve to solve the coordination problems implicit in chaotic capital flight, and thus to avoid some of its worst effects. If, aside from illiquidity, there are problems with the debt burden of the country concerned, this mechanism would also serve to distribute more equitably the

costs of adjustment and, particularly, to force private creditors to pay (also in an equitable way among themselves) a part of the burden.

Due to the effects that the use of this mechanism may have on the credit reputation of the borrowing countries and its collateral effects on trade financing, the countries concerned are unlikely to use these provisions, except under severe difficulties. However, to avoid moral hazard on the side of borrowers, they must be subject to some control. According to UNCTAD, which has provided probably the most forceful defence of this mechanism, there could be two alternatives (UNCTAD 1998: Part I/ch. 4; UN Task Force 1999; and Akyüz and Cornford in this volume). The first would be to explicitly give the IMF the power to sanction such standstills, to lead the renegotiations and to facilitate 'lending into arrears' only in these cases. The second alternative would be to allow countries to unilaterally call the standstill, but then to submit it for approval to an independent international panel, whose sanction would then give it legitimacy. A third, complementary possibility would be to draft *ex-ante* rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks are experienced. These rules, at times, have been incorporated into debt renegotiation agreements.

We should emphasize that this mechanism has four implications. First, to avoid free riding, the mechanism requires the *generalized* adoption of 'collective action clauses' in international lending. Secondly, 'bailing in' should be encouraged, by giving preference to lending that is given to the country involved throughout the period during which the standstill is in effect and a later phase of 'normalization' of capital flows. Thirdly, debt renegotiations under this framework must have a strictly agreed, short time-horizon, beyond which the IMF or the international panel would have the authority to determine the

terms of rescheduling. To avoid repeated renegotiations, which have been one of the most troublesome features of debt rescheduling over the past two decades, the renegotiation should aim for a definite settlement, i.e., in which the debt burden is sustainable. The external debt, public and private, should thus be classified in three portions: (i) the first component to be subject to normal servicing, which would include the 'bailing in' operations; (ii) the contingent portion to be paid totally or partially, depending on certain external and domestic conditions (e.g., terms of trade and normalization of borrowing, in the first case; economic activity or unemployment, in the second); and (iii) the third portion to be written off. Finally, utilizing this mechanism would necessitate the use of explicit controls on capital flows, which must extend for some time beyond the successful conclusion of renegotiations.

2.5. Social safety nets

In recent debates, emphasis has correctly also been placed on the role that multilateral financial institutions, particularly development banks, should play in financing social safety nets in developing countries. Strong social safety nets are, indeed, essential in managing the social repercussions of financial vulnerability in the developing world. The concept itself is subject to some confusion, as it is used to refer both to the design of long-term social policies and to specific mechanisms to protect vulnerable groups during crises. The term should probably be used to refer specifically to the latter, although these arrangements should be part of a stable mechanism of social protection. Multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter.

Recent analyses have come to some basic conclusions about these programmes. Firstly, safety nets must be a part of *permanent* social protection schemes, as only a permanent scheme guarantees that the programme coverage will respond without lags to the demand of vulnerable sectors for protection during crises (Cornia 1999). This implies, in turn, that financing must be fundamentally of a domestic character, with external financing contributing marginally, if at all, during crises. Secondly, given the heterogeneity of labour markets in developing countries, a combination of several programmes with different target groups is necessary (Márquez 1999). Thirdly, these programmes must be adequately financed and should not crowd out resources from long-term investment in human capital. This, it must be said, leads to a fourth conclusion: that the effective functioning of social safety nets requires that public-sector expenditure should include anti-cyclical components. This would be impossible—without generating inefficiencies in the rest of public-sector expenditure—unless fiscal policy as a whole is counter-cyclical. In the absence of this anti-cyclical fiscal pattern, external financing from development banks during crises will be unnecessary or, at best, illusory, as overall net fiscal financing requirements will actually decrease despite the increased spending associated to social safety nets.

3. AREAS OF DISAGREEMENT

3.1. The provision of adequate emergency financing

As we have pointed out, the agreed principle that emergency financing should be available has not been matched by a clear agreement on how to make funds available in adequate

quantities to be really effective. The current principles of IMF intervention were summarized in the April 1998 Interim Committee Communiqué: 'The Fund cannot be expected to be able to finance whatever large balance-of-payments deficit. Its role is essential to catalyse other sources of financing, and, when needed, to coordinate support from other sources'. However, as we have pointed out, under crisis conditions, its 'catalytic' and 'coordination' roles would be largely ineffective if the market judges the intervening authorities to be unable or unwilling to supply funds in the quantities required. Thus, insufficient resources may turn two correct principles—emergency financing and the catalytic role of the Fund—largely into a dead letter.

Thus, even if no true lender of last resort were devised (as we assume it will not), a well-funded 'emergency financier' would certainly be required. This, for developing countries, must be a *sine qua non* of any reform effort. As bilateral financing and contributions to the IMF will continue to be very scarce, the best solution is certainly to allow additional issues of SDRs under critical financial conditions, to create the additional liquidity required. These funds could be reallocated once financial conditions normalize (UN Task Force 1999). This procedure would, by the way, create an anticyclical element in world liquidity management and would give SDRs an increasing role in world finance, a principle that developing countries advocated in the past and should continue to do. Second best alternatives are to make a more active use of central bank swap arrangements under IMF or BIS leadership, or to allow the IMF to raise the resources needed in the market.

3.2. IMF conditionality

IMF conditionality has long been an area of contention. However, in recent years—and even decades—the issue has become increasingly troublesome for three different reasons. First, the scope of conditionality has been gradually expanded to include not only the realms of other international organizations, but also of domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated, 'by their very nature, should be decided by legitimate national authorities, based on broad social consensus'.⁵ Indeed, although not referred explicitly to IMF conditionality, this point has been made in strong terms by the president of the World Bank: 'We must never stop reminding ourselves that it is up to the government and its people to decide what their priorities should be. We must never stop reminding ourselves that we cannot and should not impose development by fiat from above, or from abroad' (Wolfensohn 1998). Secondly, whereas the legitimacy of conditionality is indisputable when domestic policies are the source of macroeconomic disequilibria that lead to financial difficulties, it is unclear how this principle applies when such difficulties are generated by contagion. Moreover, it is even less clear why conditionality should be mixed in this case with adverse credit conditions (higher interest rates and shorter maturities), as has been advocated by the Group of Seven and agreed to in the case of the new credit windows created in recent years. Finally, evidence of overkill in some IMF programmes has accumulated and has led to mounting criticisms on the specific macroeconomic analysis implicit in the programmes. Due to this fact, with a significant lag, the IMF itself facilitated countercyclical fiscal management in the depressed Asian economies (Fischer 1998).

Even if the legitimacy of the principle of conditionality is accepted—or, as it is sometimes alternatively stated, 'support in exchange for reforms'—these are thus reasons that should lead to a major revision of the characteristics of such conditionality. Indeed, the perception that conditionality has gone too far in practice may undermine its legitimacy, and weaken the international consensus on which the IMF itself is built. Thus, a strong argument can be made that the way to restore full confidence in the principle of conditionality is by reaching a renewed international agreement on how it should be used.

Several principles can be advanced in this regard. Firstly, conditionality should be restricted to the macroeconomic policies that were its purview in the past. It should be used when expansionary policies are clearly associated with the generation of macroeconomic imbalances, or when a country needs to draw Fund resources beyond some automatic low-conditionality facilities if the source of the imbalance is an international shock. Reforms of domestic prudential regulation and supervision may also be required, but parallel agreements should be made with the corresponding international authorities (a still controversial issue, as we have seen). Secondly, low-conditionality facilities should be available in adequate quantities when the source of the imbalance is an international shock. This principle should be clearly applied to the case of contagion, where *ex-ante* criteria could be used to determine eligibility for the available windows. Thirdly, more stringent credit conditions should not be used as a complement to conditionality, as it undermines the 'credit union' character of the IMF without really approaching 'market conditions' that, under such circumstances, would be very stringent. Fourthly, automatic rules should be agreed when signing an agreement with the Fund, by which the restrictiveness of policies would be eased should evidence of 'overkill' become clear. Finally, regular official evaluation of IMF programmes, either by an autonomous

division in the Fund (as it is done in the World Bank) or by outside analysts, should be introduced and the major conclusions of these evaluations, when reviewed by the Board, should be explicitly introduced into regular Fund practice.

3.3. Preservation of the autonomy of developing countries to manage the capital account

Massive evidence of capital account liberalizations that induced major external and domestic financial crises in many countries has led to several agreements in this area.⁶ It is now generally agreed that such liberalizations should be gradual, should emphasize longer-term flows and be extremely cautious with shorter-term and volatile funds (such as short-term credits and portfolio flows), and should be preceded by the development of strong prudential regulation and supervision, and consistent macroeconomic policies. Moreover, it is also accepted that any international agreement in this area should include safeguard mechanisms that would allow a temporary use of controls under certain, critical conditions. The consensus stops at this point. A strong argument has been made by some analysts to place well-managed capital account liberalization as the final objective of policy, on the basis that freer capital markets are inherently good for growth. If these assertions were correct, the use of capital controls should be essentially a temporary device. These are the arguments that underlie the current discussion on the introduction of capital account convertibility into the Articles of Agreement of the IMF. A strong argument can be made, however, on the advantages of maintaining the autonomy of developing countries to manage capital accounts, on at least four grounds.⁷

First of all, some of the fundamental assumptions that underlie full capital account liberalization are wrong. There is no evidence that capital mobility allows an efficient smoothing out of expenditure in developing countries through the economic cycle. On the contrary, in these countries the volatility of capital flows is clearly an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and some evidence in the opposite direction.⁸ A simple way to explain this result is to argue that, even if it is true that freer capital markets, through their effect on a more efficient savings-investment allocation, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect.

Secondly, capital account regulations are obviously costly, but they also generate benefits. In particular, if they are not used as substitutes for appropriate macroeconomic management, the additional degrees of freedom they provide to economic policy are important. During financial booms, a form of tax or control on inflows provides an additional mechanism to 'lean against the wind' and thus avoid excessive borrowing, particularly of a short-term character, thereby acting as an effective mechanism to prevent financial crisis. In countries that use some form of managed exchange rate flexibility, they also help to avoid an excessive appreciation of the domestic currency in the face of favourable terms of trade or capital account shocks, avoiding the generation of current account positions that become unsustainable once these favourable shocks cease. In terms of our discussion in section 1, they may be one of the least costly forms of 'self-insurance' that a country may choose. It is certainly preferable to allowing the economy to boom without restrictions, accumulating excessive risks, and may be better than sterilized reserve accumulation, a policy that has been found to be self-defeating in many

developing countries. During crises, controls on outflows provide additional 'room for manoeuvre', if they are not used as a substitute for fundamental macroeconomic adjustment. As we have argued, they are also a necessary complement to debt standstills, generally viewed as an important ingredient of a necessary financial architecture (Krugman 1998).

Thirdly, it can be argued that some capital account regulation on inflows used by some developing countries during boom years may be not only more effective but actually preferable to alternative prudential regulation and supervision. Indeed, the boundary between some forms of capital controls and prudential regulation is a thin one. This is associated to the fact that capital account regulations have both macro and microeconomic effects, and may thus serve in the latter case as a substitute for prudential regulations aimed at avoiding unsustainable credit booms or guaranteeing a certain structure of assets or liabilities of financial intermediaries. As we have pointed out, prudential regulations in some cases establish price signals, but also quantitative restrictions, and although financial supervision is an essential activity, it is not free from significant information problems, or those associated with discretionary public sector interventions. Certain types of regulations of the capital account may thus be equivalent to or a near substitute for traditional quantitative prudential regulations (e.g., explicit prohibition of a certain type of external borrowing, or a minimum stay period for portfolio capital) or may introduce a price signal to substitute for quantitative restrictions (such as a Tobin tax, or the system of reserve requirements on capital flows to discourage the short-term indebtedness extensively used by Chile and Colombia in the 1990s) (Agosin and Ffrench-Davis 2000; Ocampo and Tovar 1999), reducing the need for more discretionary interventions. Equivalent practices, such as the selling fees imposed by mutual funds on investments held for a short period,

are actually used by private agents in order to discourage short-term holdings (J. P. Morgan 1998: 23). Moreover, whereas prudential regulation and supervision cover only financial intermediaries, capital account regulations have a more extensive coverage. Given the significant externalities that non-financial agents have on domestic financial stability, this is a significant advantage.

Finally, but no less important, it is unclear why developing countries, in the absence of an adequate international financial safety net, should give away their autonomy in this area. This is a crucial point. Why should developing countries give up this degree of freedom if they do not have access to adequate emergency financing with well-defined conditionality rules? In terms of our discussion in section 1, this is a particularly crucial issue for countries without significant power in the international arena, for whom renouncing any possible means to manage a crisis is a costly alternative.

Thus, at least in the case of developing countries, a flexible approach is superior to capital account convertibility. Thus, the mandate of the IMF should not be for convertibility, but rather for analysing and spreading good practices in this area. Based on the Latin American experience, three issues may be pointed out:

- i) Capital account regulations during booms, which have a preventive character, would be preferable to the establishment of strong quantitative controls on outflows during the ensuing crises, which generate severe credibility issues;
- ii) Price-based regulations (such as reserve requirements on capital inflows) are an alternative to quantitative controls, but simple quantitative controls (e.g., flat

prohibitions on certain activities or regulations) may be preferable in underdeveloped regulatory regimes; and,

- iii) A permanent regulation or control regime that is tightened or loosened throughout the economic cycle is clearly superior to the alternation of a free capital account regime during the boom and quantitative controls on outflows during the crisis. This type of sporadic, crisis-driven controls generate serious credibility issues and are generally ineffective, as a tradition of regulation and supervision is necessary to make them operative.

3.4. Freedom to choose the exchange rate regime should continue

In the face of recent events, some authors have strongly argued that the only stable regimes in the current globalized world are either a convertibility scheme or a totally free exchange rate. According to this point of view, the IMF should stop countries from adopting exchange rate regimes that are assumed to be unstable. This argument is obviously only one step from arguing that the exchange rate regime should be subject to conditionality, a step that would certainly be unfortunate.

The free-versus-floating exchange rate controversy is an old one and indicates that no optimal regime exists. Currency boards certainly introduce built-in institutional arrangements that provide for fiscal and monetary discipline, but they reduce the room for stabilizing macroeconomic policies and may thus generate strong swings in economic activity and asset prices. Probably as a result of this, these arrangements are not speculation-proof, as the experience of Argentina in 1994-95 or Hong Kong in 1997 indicates. On the other hand, the classic arguments in favour of floating rates are that these

provide a market mechanism to face both trade and capital account shocks, and allow authorities an additional degree of freedom to manage monetary policy to respond to domestic anti-cyclical goals. However, exchange rate volatility increases the costs of trade transactions and thus reduces the benefits of international specialization. During periods of financial euphoria or exceptional terms of trade, appreciation may generate Dutch disease effects. The existence of financial liabilities in foreign currencies generates additional difficulties, as exchange rate fluctuations generate significant capital gains and losses, which tend to be strongly procyclical. Probably as a result of these links between the exchange rate and financial structures, the essential advantage of a floating exchange rate—that of allowing authorities to determine monetary policy on the basis of domestic factors—does not always materialize. Contrary to that rule, the experience of both domestic policies and IMF programmes is that under floating rates, authorities tend to use monetary policy to counteract market pressures on exchange rates.

In practice most countries choose intermediate regimes, such as adjustable and crawling pegs, exchange rate bands and dirty floatation. The basic argument for an intermediate exchange rate regime is that it may counteract some of the adverse characteristics of free floating, while maintaining the advantages of utilizing the exchange rate as a policy tool. However, at several stages in the business cycle, such intermediate regimes may lead authorities to use interest rate management as a support for exchange rate management. This may be socially very costly if an inappropriate exchange rate is defended.

As long as no compelling argument exists in favour of one or a few specific alternatives, countries should be free to choose the exchange rate regime that they find preferable. National authorities and IMF surveillance and conditionality should recognize in this case,

however, that other policies might have to be adjusted accordingly. In particular, domestic regulation will have to take into account the specific macroeconomic risks that financial intermediaries face under a particular regime. Equally important, complementary capital account regulations may be useful to moderate shocks in either direction. Thus, regulation or controls on inflows may be useful during the boom to avoid reducing interest rates in a pro-cyclical way and thus feeding the expansion of aggregate domestic demand. In turn, controls on outflows during crises may be a useful alternative to high domestic interest rates, which have strong effects on aggregate demand and on the stability of the domestic financial system.

3.5. The role of regional institutions in the new architecture

There are at least three arguments in support of a strong role for regional institutions in the new financial order. The first one is that globalization also entails open regionalism. The growth of intraregional trade and investment flows is, indeed, a striking feature of the ongoing globalization process. This increases macroeconomic linkages and thus the demands for certain services provided by the international financial system which we have analysed in previous sections: surveillance and consultation of macroeconomic policies, and mutual surveillance of each other's mechanisms for the prudential regulation and supervision of the financial system, in particular.

Secondly, it is unclear whether there are strong scale economies to justify international institutions in specific areas. Traditional issues of subsidiarity are thus raised. For example, macroeconomic consultation and surveillance at the world level would certainly be inefficient to manage the externalities of macroeconomic policies among neighbours in

the developing world (or even within Europe). Due to differences in legal traditions and the sheer scale of the diseconomies involved, surveillance of national systems for the prudential regulation and supervision of financial sectors, and even the definition of specific minimum standards in this area, may be dealt with more appropriately with the support of regional institutions. Also, although regional and international contagion implies that the management of the largest balance-of-payments crises should be assigned to a single world institution, it is unclear how far we should push this assertion. Strong regional institutions can serve as regional buffers; the postwar Western European experience provides the best example in this regard. Moreover, even in major crises, regional reserve funds can play a role (as the experience of the Andean [now Latin American] Reserve Fund indicates) and, if expanded, could even provide full support to the small and medium-size countries within some regions.

The third argument was already put forward in section 1: for smaller countries, the access to a broader menu of alternatives to manage a crisis is relatively more important than the 'global public goods' that the largest international organizations provide (e.g., global macroeconomic stability) and upon which they will assume they have little or no influence. Due to their small size, their negotiation power vis-à-vis large organizations would be very limited, and their most important defence is, therefore, competition in the provision of financial services from such institutions to them.

There may be a fourth, political economy, argument: countries are likely to take quite different attitudes to the analyses made by international and regional organizations (and to the attached conditionality). They are thus more likely to 'own' the latter, as they feel they

have a stronger voice in the analyses made by regional organizations, a fact that will improve rather than reduce effectiveness.

Thus, although the current discussion has underscored the fact that some services provided by international financial institutions, including some clear 'global public goods', are being undersupplied, it would be wrong to conclude from this statement that an increasing supply should come from a few world organizations. Rather, the organizational structure required should, in some cases, have the institutional nature of the networks that provide services required on a complementary basis, while in other instances, it should function as a system of competitive organizations. The provision of services required for the prevention and management of financial crises should probably resemble the first model, but it would also be desirable if various parts of the network compete with each other (e.g., regional reserve funds versus the IMF in the provision of emergency financing to smaller countries).

This implies that the International Monetary Fund of the future should not be viewed as a single, global institution, but rather as the apex of a network of regional and subregional reserve funds. To encourage the development of the latter, incentives could be created by which common reserve funds could have automatic access to IMF financing and/or a share in the allocation of SDRs proportional to their paid-in resources—in other words, contributions to common reserve funds would be treated as equivalent to IMF quotas. As noted, regional reserve funds could provide most of the exceptional financing for smaller countries within a region, but also part of the financing for larger countries, and they could also serve to deter, at least partly, would-be speculators from attacking the currencies of individual countries.

This model should be extended to the provision of macroeconomic consultation and surveillance. This would complement, rather than substitute, regular IMF surveillance. In the area of prudential regulation and supervision, more elaborate systems of regional information and consultation, including the design of specific regional 'minimum standards', can also play a positive role. Again, peer reviews should be part of this system. In the case of debt standstills and workouts, regional mechanisms should at least play a role in assessing the specific regional impacts that they may have.

An institutional framework such as that suggested would have two positive features. First of all, it would bring more stability to the world economy by providing essential services that can hardly be provided by a few international institutions, particularly in the face of a dynamic process of open regionalism. Secondly, from the point of view of the equilibrium of world relations, it would be more balanced than a system based on a few world organizations. This would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

4. CONCLUSIONS

This chapter argues that the instability experienced by the international financial system in recent years (and decades) not only reflects characteristics that are inherent in financial markets, but also flaws of the 'narrow' international financial architecture relating to the prevention and management of financial crises. These shortcomings are extremely costly for developing countries. A comprehensive reform is therefore needed, including not only

areas in which, according to the author's personal evaluation, there is some degree of agreement, but also those in which significant divergence of opinion remains.

At the outset, the chapter sets forth four essential propositions that must be taken into account in any substantive reform. Firstly, the 'information' problems that generate market instability are largely unsolvable, since financial market behaviour is determined as much by opinions and expectations as by factual information. Accordingly, a greater flow of information is unlikely, by itself, to make financial markets more stable and, indeed, the asymmetry between the sophistication of financial markets and the simple way opinions and expectations are formed could cause greater flows of information to increase instability rather than reduce it. Second, as in any other area, 'self-insurance' is a costly option in international finance. So although preventive policies need to be adopted by developing countries, they are costly and insufficient by themselves. Thirdly, any system would have to rely largely on networks of national institutions, since countries are unlikely to give up financial sovereignty entirely. Finally, no international financial design would be neutral in terms of equilibrium in international relations. This is particularly important for small players, who would prefer more democratic forums with more—rather than fewer—institutions.

The chapter identifies five areas in which some degree of agreement exists. The first of these is the need for industrialized countries to implement expansionary policies during crises. Second, the system requires emergency financing to be made available before international reserves are depleted rather than afterwards; a basic conceptual change vis-à-vis the principle of 'fundamental disequilibrium' in the balance of payments adopted at Bretton Woods. Thirdly, the institutional framework in which financial markets operate

should be strengthened, so as to provide markets with more information, and adopt common standards in prudential regulation and supervision, together with codes of conduct in several areas. On the other hand, the chapter argues against the excessive optimism that some institutions and authors place on this as the crucial (and even sole) area of reform. In the fourth place, the system needs stronger mechanisms of macroeconomic consultation and surveillance, with adequate developing country representation, which operate during booms as well as during crises. These mechanisms should guarantee the global consistency of the macroeconomic policies of industrialized countries. Fifth, the system also requires the design of internationally sanctioned standstill provisions (orderly debt workouts) so as to ensure an adequate sharing of the burdens of adjustment between countries and private financial agents during crises.

The chapter identifies five areas that must also be dealt with in a comprehensive reform of the current system, on which significant difference of opinion remains. The first of these is the need to have adequate funds available for emergency financing during crises, for which the chapter strongly argues in favour of counter cyclical issues (and retirements) of SDRs. Secondly, the chapter argues against extending the scope of IMF conditionality, which has expanded excessively over the past two decades; this should be confirmed to the macroeconomic areas that were its purview in the past. Third, the chapter argues strongly in favour of preserving the autonomy of developing countries to manage their capital accounts. Indeed, it claims that, given the inherent instability of financial markets and current flaws in the system, the regulation of capital inflows by developing countries during booms is essential for averting financial crises, and it may even be necessary to adopt other preventive policies as well. Along the same line of reasoning, the chapter also argues for maintaining total autonomy for developing countries to choose their exchange

rate regime. Finally, the chapter argues in favour of a leading role for strong regional institutions in the new architecture. In this particular area, competition in the provision of international financial services is particularly important for smaller countries which suggests that more, rather than fewer, institutions are required for a more balanced international financial architecture.

NOTES

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¹ A broader set of issues is analysed in Ocampo (1999).

² See, for instance, the classic paper by Stiglitz and Weiss (1981).

³ This idea was captured by Keynes' concept of the 'beauty contest'. See Eatwell (1996).

⁴ See Camdessus (1998); IMF (1998); IMF Interim Committee (1998); Group of Seven (1998), UN Task Force (1999); Miyazawa (1998); Rubin (1999); Eatwell and Taylor (2000); Eichengreen (1999); Griffith-Jones (1998), and Wyplosz (1999), among others.

⁵ See UN Task Force (1999: Section 5). Actually, the strongest statement in this regard has come from Feldstein (1998), a conservative critic of the Fund.

⁶ For a recent survey, see Williamson and Mahar (1998).

⁷ For a more extensive analysis of these issues, see UN Task Force (1999); UNCTAD (1998: Part I/ch. 4); ECLAC (1998a: Part III); Akyüz and Cornford (this volume); Eichengreen (1998, 1999); Griffith-Jones (1998); Grilli and Milesi-Ferretti (1995); Krugman (1998), and Rodrik (1998).

⁸ See, in particular, Eatwell (1996) and Rodrik (1998).

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