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### Macroeconomic policy questions: financing of development, including net transfer of resources between developing and developed countries

## The financial crisis and its impact on growth and development, especially in the developing countries

### Note by the United Nations Conference on Trade and Development

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## **I. External financing for developing countries: trends and prospects**

1. As shown in table 1, the size, composition and distribution of external capital inflows<sup>1</sup> to developing countries have all undergone fundamental shifts during the past three decades. Net capital inflows to developing countries in real terms (that is to say, in terms of their purchasing power over foreign goods) have risen fivefold. However, importantly, measured in terms of the share of output of the recipient countries, the recent surge in capital flows represents only a recovery from the stagnant levels of the 1980s rather than an increase over the levels attained during the years preceding the debt crisis. From 1975 until the early 1980s, private capital accounted for almost two thirds of total inflows, but after 1982, its share fell to less than 50 per cent, not so much because of a rise in official finance as because of a collapse in private inflows, notably international bank lending. In the 1990s, the surge in capital flows and the decline in official financing have meant that private capital has accounted for 80 per cent of total capital inflows to developing countries. These changes in the composition of capital inflows as between public and private sources have been accompanied by shifts in their distribution among developing countries and regions. In particular, since official flows tend to favour poorer developing countries and regions, their decline relative to that of private capital flows has been a major determinant of the recent contraction of their share of total inflows.<sup>2</sup>

2. The impact of the Asian financial crisis and of other recent difficulties in international financial markets on net private capital inflows to developing and transition economies is indicated in more detail by estimates (shown in table 2) for 1998 of the International Monetary Fund (IMF) and of two private sector institutions (which cover a smaller sample of countries).<sup>3</sup> These estimates of net flows of private capital to such economies show a fall of 50-70 per cent. The incidence and scale of the declines in 1996-1998 vary significantly among different regions: those for Asian economies, for example, have been larger than elsewhere and began earliest, while those for Latin America have been more moderate but are expected to begin their recovery later.<sup>4</sup> Net inflows of foreign direct investment (FDI) have been relatively little affected by recent financial crises. By contrast, net debt inflows have fallen very sharply.

3. Forecasts for private capital flows to developing and transition economies for the second half of 1998 and for 1999 were revised sharply downwards in the aftermath of the Russian crisis during the summer of 1998. A substantial recovery of private capital flows is not expected until 2000. As in the case of flows actually realized since 1996, forecasts of net FDI have been less affected by unfavourable developments since mid-1998. The region whose forecasts have been most sharply marked down since mid-1998 is Latin America, though recently the outlook has become a little more optimistic. The emerging markets of East and South Asia by contrast are expected to experience a moderate recovery in their net private capital inflows in 1999.

## **II. Financial instability and crises**

4. Since the collapse of the Bretton Woods system, increased global capital mobility has been accompanied by greater frequency of financial crises in both developed and developing countries.<sup>5</sup> There are, however, important differences between industrialized and developing countries in the nature and effects of financial instability and crises. Experience shows that,

Table 1  
**Net capital inflows to developing countries**  
 (Percentage of gross national product (GNP))

	1975-1982	1983-1989	1990-1998
Total net capital inflows	4.91	2.87	5.00
Total net capital inflows, excluding China	5.45	2.97	4.22
Official	1.58	1.57	1.03
Official development assistance (ODA)	0.53	0.62	0.56
Other official	1.05	0.96	0.47
Private	3.33	1.29	3.97
Non-debt creating	0.42	0.55	2.21
Foreign direct investment	0.42	0.53	1.67
Portfolio equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank loans	2.46	0.44	1.17
Short-term	1.10	0.10	0.72
Long-term	1.36	0.34	0.44
<i>Memo item:</i>			
Portfolio inflows	0.12	0.07	1.06
Net capital transfers	2.48	-0.26	2.65
Interest payments	1.49	2.58	1.79
Profit remittances	0.93	0.54	0.56

Source: United Nations Conference on Trade and Development (UNCTAD) secretariat estimates, based on World Bank, *Global Development Finance*, 1999 (CD-ROM) (Washington, D.C., 1999).

Note: The term *capital inflow* is used here to encompass the acquisition of domestic assets by *non-residents*. Their sales of domestic assets are defined as a negative capital inflow. Thus the term "net capital inflows" denotes acquisition minus sales of domestic assets by non-residents. The types of assets included vary between institutions defining such inflows for the purpose of the data they publish. The term *net resource flows* used in the World Bank's reports on *Global Development Finance*, for example, refers to capital transactions by non-residents, but does not include those that give rise to short-term debt. In the International Monetary Fund (IMF) *Balance of Payment Statistics*, capital inflows are items included in the capital and financial accounts of the balance of payments. These items comprise mainly credit items included under the heading of capital transfer (such as debt forgiveness and migrants' transfers), direct investment in the country concerned, and the liability items under portfolio investment and other investment (which includes both short-term and long-term debt in such forms as bank loans, other types of trade credit, and borrowing from IMF).

Table 2  
**Estimates by three institutions of net capital flows to developing and transition economies, 1996-2000**

(Billions of dollars)

<i>Type of flow/region</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999<sup>a</sup></i>	<i>2000<sup>a</sup></i>
<b>Estimates of J P Morgan</b>					
<b>Net private capital inflows</b>					
Total	336	290	170	137	160
<i>Net debt inflows</i>	205	154	56	1	18
Medium- and long-term	133	178	136	22	12
Short-term	72	-24	-81	-22	6
<i>Net equity inflows</i>	131	136	114	136	142
Net portfolio investment	19	-8	-17	28	25
Net direct investment	112	143	130	108	118
Asia	177	106	17	32	42
Europe and Africa	67	83	45	43	53
Latin America	92	101	108	62	65
<b>Estimates of the Institute of International Finance</b>					
<b>Net private capital inflows</b>					
Total	328	263	143	141	..
<i>Private creditors</i>	199	121	20	16	..
Commercial banks	120	32	-29	-12	..
Non-bank private creditors	79	89	49	28	..
<i>Equity investment</i>	129	142	123	125	..
Direct equity	93	116	120	103	..
Portfolio equity	36	26	2	22	..
Africa/Middle East	6	16	8	10	..
Asia/Pacific	170	71	8	29	..
Europe	48	69	42	36	..
Latin America	104	106	85	66	..
<b>Estimates of the International Monetary Fund</b>					
<b>Net private capital flows<sup>b</sup></b>					
Total	212	149	64	67	145
Net direct investment	116	143	131	117	123
Net portfolio investment	81	67	37	8	44
Other net investment	15	-60	-103	-58	-22
Africa	8	16	10	12	17
Net direct investment	6	8	7	8	8
Net portfolio investment	0	3	4	1	2
Other net investment	2	6	0	3	6
Asia	101	3	-55	-32	3
Net direct investment	55	63	50	41	46

Type of flow/region	1996	1997	1998	1999 <sup>a</sup>	2000 <sup>a</sup>
Net portfolio investment	13	1	-15	-17	-2
Other net investment	33	-60	-89	-57	-41
Middle East and Europe	7	17	27	26	21
Net direct investment	2	3	3	5	6
Net portfolio investment	4	4	9	8	10
Other net investment	0	9	15	13	4
Western hemisphere	82	87	69	38	83
Net direct investment	39	51	54	46	44
Net portfolio investment	40	40	33	2	23
Other net investment	3	-3	-18	-9	16
Transition economies	15	26	14	23	23
New direct investment	14	19	17	18	19
Net portfolio investment	24	19	7	14	11
Other net investment	-23	-12	-11	-8	-8

Sources: J P Morgan, *World Financial Markets*, 2 July 1999; Institute of International Finance (IIF), *Capital Flows to Emerging Market Economies*, 25 April 1999; IMF, *World Economic Outlook*, May 1999, table 2.5.

<sup>a</sup> Forecast.

<sup>b</sup> Other net investment comprises trade credits, loans, currency and deposits, and other assets and liabilities. For further explanations, see text and note 23.

Note: The sample used by IIF for its publication *Capital Flows to Emerging Market Economies* consists of 29 developing and transition economies. That of J P Morgan in its publication *World Financial Markets* can be assumed to be similar but not identical. The number of countries included in the IMF groupings is more comprehensive, and IMF's figures are after subtraction of net lending by residents of the recipient economy (this helps to explain why they are lower than those of IIF even though they are based on larger groupings). In view of the similarity of the size of the figures of IIF and J P Morgan, it is reasonable to assume that they are estimated on a broadly similar basis.

Two dots (..) in table mean estimate is unavailable.

in developing countries, reversal of external capital flows and sharp declines in the currency often threaten domestic financial stability. Similarly, domestic financial crises usually translate into currency turmoil, payments difficulties and even external debt crises. By contrast, currency turmoil in industrialized countries does not usually spill over into domestic financial markets, nor do domestic financial disruptions necessarily lead to currency and payments crises. These differences between developing and developed countries stem from a number of factors. First, the size of developing country financial markets is small, so that entry or exit of even medium-sized investors from industrialized countries is capable of causing considerable price fluctuations. Furthermore, differences in the net foreign asset position and the currency denomination of external debt play a crucial role.<sup>6</sup> Here the vulnerability of developing countries is greater because of their typically higher net external indebtedness and the higher shares of their external debt denominated in foreign currencies. The vulnerability of the domestic financial system is increased further when external debt is owed by the private sector rather than by sovereign Governments.

5. Financial crises in developing countries are frequently, but not always, associated with a deterioration in the macroeconomic conditions of the recipient country which often results

from the effects of capital inflows themselves and from external developments affecting interest rates and exchange rates in international markets, rather than from shortcomings in macroeconomic policies. Such crises are all characterized by a rush of investors and creditors to exit and a consequent financial panic. In the absence of a large stock of reserves or access to international liquidity, the ability of a debtor developing country to repay its entire stock of short-term external debt on demand is no greater than the ability of a bank to meet a run by its depositors. Withdrawal of loans by foreign creditors is likely to trigger a rush by unhedged private debtors into foreign currency as they seek to pay down debt or cover their open positions, as well as a flight from non-debt instruments held by non-residents, notably from the equity market. That this rush in turn drives down the foreign exchange value of the domestic currency and raises interest rates makes it more difficult for debtors to service their debt, thereby forcing them to liquidate assets and setting off a debt-deflation process.

### **III. Policy responses**

6. Some of the possible lines of defence against financial crises involve action at the national level. These include domestic macroeconomic policies, and hedging through keeping sufficient foreign exchange reserves and credit lines. Recent experience has pointed to serious weaknesses of macroeconomic policy as a response to currency runs and banking crises. Reliance on foreign exchange reserves and credit lines is likely to be costly and to afford, at best, partial protection. As a result, attention has increasingly turned to structural and institutional weaknesses in the global financial architecture regarding the prevention and management of financial crises. The resulting debate has concentrated on five issues: (a) transparency, disclosure and early warning systems; (b) financial regulation and supervision; (c) surveillance of national policies; (d) an international lender of last resort; and (e) orderly debt workouts.<sup>7</sup>

#### **A. Monetary policies**

7. The orthodox policy response to a debt run by monetary tightening and high interest rates has not proved effective in recent financial crises. When financial markets panic, the likely effects of such a policy on capital flows tend to be perverse because of the strong adverse influence on credit risk. The withdrawal of foreign lending and flight from the country begin in the first place because lenders and investors do not expect to receive the return on their assets. Higher interest rates all too frequently signal declining creditworthiness and rising default risk, and the expected rate of return adjusted for risk thus tends to fall as interest rates are raised. If persistently applied, monetary tightening and high interest rates can eventually stabilize the currency by intensifying the difficulties of the debtors and increasing bankruptcies and defaults, that is to say, by reducing the sales rather than by increasing the purchases of domestic currency. However, stabilization of markets by monetary tightening will often be a slow process, and there is a serious risk that it will eventually be achieved more by depressing the economy than by bringing back foreign capital.

#### **B. Foreign exchange reserves and lines of credit**

8. It has been suggested that debtor countries should maintain adequate reserves to meet their short-term obligations in order to avoid currency turmoil in the face of a massive withdrawal of foreign loans and investment. However, the consequences of accumulating

reserves by borrowing are quite different from those of accumulating them through trade surpluses. One way of building up such reserves is to sterilize capital inflows through the issue of domestic public debt. Such a strategy can be costly to the economy since the return on foreign reserves generally falls short of the cost of external borrowing.

9. A variant of this proposal is for the public sector fully to cover the external short-term liabilities of the private sector by borrowing at long term and investing at short term abroad. However, not all Governments have access to long-term foreign borrowing. More importantly, the cost of such an operation can also be very high, particularly when the international long-term rates exceed short-term rates by a large margin and the risk premium on long-term sovereign debt is high. Another strategy — which is tantamount to arranging a private lender-of-last-resort facility — would be to maintain credit lines with foreign private banks and to use them when faced with an attack. Again, however, this will work only so long as not too large a credit line is sought. Moreover, the costs involved can be very large.

### **C. Transparency, disclosure and early warning**

10. The Asian financial crisis has accelerated initiatives to improve the timeliness and quality of information concerning key macroeconomic variables as well as the financial reporting of banks and non-financial firms.<sup>8</sup> These are viewed as essential for better decision-taking by private lenders and investors, greater market discipline over policy makers, more effective policy surveillance by multilateral financial institutions, and strengthened financial regulation and supervision.

11. Regarding key macroeconomic variables, an initiative had already been taken after the Mexican crisis when IMF established the Special Data Dissemination Standard (SDDS) in April 1996 to guide member countries in the public dissemination of economic and financial information in the context of seeking or maintaining access to international financial markets. At the time it was hoped that the new, more stringent rules associated with SDDS would serve as an early warning system that would help to prevent future financial crises. However, the rules did not make such a contribution in the case of the East Asian crisis. In April 1998, the Interim Committee proposed a broadening of SDDS, so that the system would also cover additional financial data such as net reserves (after allowance for central banks' liabilities under forward or derivative transactions), the debt (in particular the short-term debt) of economic agents and other indicators bearing on the stability of the financial sector.

12. The usefulness of SDDS notwithstanding, emphasis on inadequate information as the major reason for failure to forecast the East Asian crisis appears misplaced or exaggerated. Although there were some important gaps in information, data were generally available concerning key variables in the countries concerned. What was missing was adequate evaluation by both multilateral financial institutions and market participants of the implications of available information for countries' ability to continue to obtain funding from the international financial markets. This was also the case during the Russian crisis.

13. Underlying the emphasis on improved transparency concerning macroeconomic variables is the implicit assumption that deterioration in a debtor country's position will manifest itself sufficiently slowly to avert sudden reversals of capital inflows. However, key parts of the deterioration (such as the accumulation in the spring of 1997 by the central bank of Thailand of a large part of the forward exchange liabilities that depleted its net foreign exchange reserves) may take place during short periods, so that improved disclosure would not necessarily protect the debtor from sudden reactions by creditors and investors which are highly concentrated in time.

14. The East Asian crisis has also focused attention on standards of accounting and financial reporting, particularly those of financial firms. At first sight, recommendations for greater transparency on the part of financial firms have an almost self-evident quality. Yet on closer scrutiny, the issues become less simple. The quality of information made available to financial supervisors has an important bearing on the effectiveness of their work. However, there is less consensus as to the benefits of disclosure to market participants. Public disclosure of information submitted to supervisors is typically subject to limits resulting from the belief that it could undermine the confidence in the financial system that regulation is intended to promote, and complicate the task of banking supervisors in handling the problems of banks in difficulty, and that it can enhance rather than diminish the likelihood of increased volatility and instability confronted by financial firms more generally. Indeed, the Basle Committee on Banking Supervision has acknowledged that “there are certain types of information that should be held confidential by banking supervisors” and that “the types of information considered sensitive vary from country to country”.<sup>9</sup>

15. Despite the widespread acknowledgement of the problems that full disclosure by financial firms may cause, there remains an important school of thought that supports the idea that full disclosure’s favourable effects, through its strengthening of market discipline, outweigh its costs. According to this view, during periods of financial stress, lack of information about a bank’s exposures to credit and market risks can create a situation in which rumours restrict the willingness of its creditors and counterparties to deal with it, thus threatening not only its own survival but possibly also that of other banks which, often also because of inadequate disclosure, appear similar to outsiders.<sup>10</sup> Market discipline may be able to play a useful role on occasion in preventing difficulties from engulfing particular banks and in containing spillover effects. However, as in the case of macroeconomic information concerning debtor countries, an implicit assumption of this argument appears to be that disclosure would reveal a financial firm’s problems not too suddenly, thereby making possible the exercise of market discipline in an orderly way which could avoid herd-like or panic-stricken reactions on the part of creditors and other counterparties; but experience shows that while problems may manifest themselves gradually, the disclosure process can nonetheless also lead to more discontinuous shifts in awareness.

16. Arguments for full disclosure also raise the question of the value of information made available by financial firms for decisions by supervisors as well as by creditors and other counterparties. Financial liberalization and innovation have greatly increased the speed at which financial firms in many countries can alter the assets and liabilities on their balance sheets, as well as their scope for taking off-balance sheet positions of an opaque nature, thereby changing the risks they face in ways that can be difficult for outsiders to identify.<sup>11</sup>

17. These limitations of accounting information would apply even if financial firms were fulfilling the requirements of best practice in this area. However, there is considerable variation even among industrialized countries in both the quantity and the form of publicly disclosed information: while arrangements for its provision are widely being strengthened, they frequently fall well short of what is now considered to be best practice.<sup>12</sup> The point emerges from recent surveys of regimes for financial reporting and the regulatory treatment of loan losses, some of the information on which is summarized in table 3.<sup>13</sup>

Table 3

**Features of financial reporting and supervision for banks in selected countries, 1992 and 1994**

	Australia	Austria	Bahrain	Belgium	Canada	Denmark	France	Germany	Hong Kong SAR	Italy	Japan	Luxembourg	Netherlands	Portugal	Ireland	Saudi Arabia	Singapore	South Africa	Spain	Switzerland	United Arab Emirates	United Kingdom	United States	
I. Consolidated accounts required	No	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	No	Yes	Yes <sup>a</sup>	Yes	Yes	Yes	Yes	Yes	Yes	
II. Accounting standards fixed by law	No	Yes	No	No	Yes	Yes	Yes	Yes	No	No	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	Yes	No	No	Yes	
III. Exemptions from disclosure obligations for banks	Yes	Yes	..	Yes	No	No	No	No	Yes	Yes	Yes <sup>b</sup>	No	No	No	No	No	Yes	Yes	No	No	No	No	No	
IV. Direct communication between auditors and supervisors in prescribed circumstances	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	Yes	No	No	Yes	Yes	Yes	Yes	Yes	No	Yes	No
V. Segmental reporting required	Yes	No	..	Yes	Yes	Yes	No	No <sup>c</sup>	No	Yes	No	Yes	Yes	Yes	No	Yes	Yes	No	No	No	..	Yes	Yes	
VI. Criteria for establishment of specific loan loss provisions	MD	..	..	MD	OR	MD	MD <sup>d</sup>	MD	..	..	MD <sup>e</sup>	MD <sup>f</sup>	MD	MD	..	..	..	..	OR	MD	..	MD	OR <sup>g</sup>	
VII. Criteria for establishment of general loan loss provisions	MD	..	..	MD	OR	OR	MD	MD	..	..	MD	OR	MD	OR	..	..	..	..	MD	MD	..	MD	OR <sup>g</sup>	
VIII. Levels of specific loan loss provisions	MD	..	..	MD	MD	MD	MD <sup>h</sup>	MD	..	..	MD	OR	MD	MD	..	..	..	..	OR	MD	..	MD	MD <sup>g</sup>	

	Australia	Austria	Bahrain	Belgium	Canada	Denmark	France	Germany	Hong Kong SAR	Italy	Japan	Luxembourg	Netherlands	Portugal	Saudi Arabia	Singapore	South Africa	Spain	Switzerland	United Arab Emirates	United Kingdom	United States	
IX. Levels of general loan loss provisions	MD	..	..	OR <sup>i</sup>	OR <sup>i</sup>	OR <sup>i</sup>	OR <sup>i</sup>	OR <sup>j</sup>	..	..	MD	OR <sup>k</sup>	OR <sup>i,k</sup>	OR <sup>j</sup>	..	..	..	..	OR <sup>ij</sup>	OR <sup>ij</sup>	..	MD	OR <sup>ij</sup>
X. Valuation of collateral	MD	..	..	MD	MD	MD	MD	MD	..	..	MD	MD <sup>l</sup>	MD	MD	..	..	..	..	OR	MD	..	MD	OR

Sources: I, II, III, IV and V: Ernst and Young, *International Bank Accounting 3rd ed.* (London, Euromoney Publications, 1999); VI, VII, VIII, IX and X: Price Waterhouse Survey of Bank Provisioning, reprinted as appendix A of V. A. Beattie and others, *Banks and Bad Debts: Accounting for Loan Losses in International Banking* (Chichester, United Kingdom, John Wiley, 1995).

Note: MD means management's discretion; OR means official rules; and two dots (..) mean information not available. Hong Kong SAR stands for Hong Kong Special Administrative Region of China.

- <sup>a</sup> Subject to exemptions for non-banking subsidiaries.
- <sup>b</sup> Reflecting flexibility regarding presentation of accounts.
- <sup>c</sup> Some breakdown of assets and liabilities required.
- <sup>d</sup> Subject to some guidelines of the French Banking Commission.
- <sup>e</sup> Subject to general regulatory guidance.
- <sup>f</sup> Subject to approval of Ministry of Finance.
- <sup>g</sup> Without distinction between specific and general loan loss provisions.
- <sup>h</sup> Subject to official guidance as to minimum levels for different categories of loan.
- <sup>i</sup> For country risk.
- <sup>j</sup> Including rules for hidden reserves.
- <sup>k</sup> Including rules set by tax authorities.
- <sup>l</sup> In consultation with Ministry of Finance.

18. In the context of efforts to improve surveillance as part of procedures for managing and preventing financial crises, there has recently been much econometric analysis of the determinants of currency and banking crises. One of the objectives of this work is the development of leading or early warning indicators. Analyses of country risk have long been standard features of the operations of firms and other institutions involved in cross-border lending and investment.<sup>14</sup> The new econometric work on currency crises represents an attempt to identify more systematically relations between, and the relative importance of, variables traditionally included in analyses of country risk (but often evaluated more informally, for example, on the basis of scoring systems). Work so far has served to clarify certain issues in international discussion of financial crises but seems likely primarily to supplement (or serve as an additional input to) pre-existing methods of analysing country risk (which, owing to their operational role, must often rely on preliminary estimates of key variables and inevitably incorporate qualitative evaluation that is specific to particular cases but has an important bearing on the likely actual outbreak of crises). The contribution of econometric work on banking crises can be expected to be similar: here too the discussion of certain issues can be clarified but it is difficult to foresee a situation where such work replaces first-hand (and sometimes confidential) information about the financial sector available to supervisors and financial firms, and the rapidly proliferating techniques used by both to analyse different types of financial risk.

#### **D. Financial regulation and supervision**

19. Weak credit evaluation and speculative lending, as well as failure to control currency risk among banks and other financial firms, are often at the origin of financial and currency crises, particularly in emerging markets. There is thus general agreement that regulatory reform is an essential part of the strengthening and restructuring of the financial sector. However, such reform is not a fail-safe way of preventing financial crises, though it can reduce their likelihood and help to contain their effects.

20. In recent years, there has been widespread reform and strengthening of financial regulation at the national level, accompanied by a proliferation of international initiatives to raise regulatory standards and to improve cooperation among supervisors. These processes have been largely driven by concerns raised in relation to financial liberalization and global financial integration. On the one hand, the diversification of their services and the increased competition that are associated with liberalization have exposed financial firms to new levels of risk, which have necessitated overhaul of financial regulation. On the other hand, global financial integration has brought in its train much greater exposure among countries to each other's financial and macroeconomic conditions and increased possibilities for the cross-border transmission of destabilizing influences, while also exposing weaknesses in banking regulation and in cross-border cooperation among banking supervisors. The main vehicles for international initiatives in financial regulation and supervision have been the Basle Committee on Banking Supervision and other bodies with close links to the Bank for International Settlements (BIS), other groups of financial supervisors, associations of exchanges such as the International Organization of Securities Commissions (IOSCO), and organizations concerned with accounting standards. The initiatives of the Basle Committee have included the adoption of principles designed to ensure that no international bank escapes adequate supervision and the prescription of levels of capital commensurate with the risks that banks run. Agreements under the latter heading were reached concerning credit risks in 1988 (the Basle Capital Accord) and market risks in 1996.<sup>15</sup>

## **1. Reform of the Basle Capital Accord**

21. Developments in the past few years have shown that the standards of the Basle Capital Accord are increasingly divorced from the credit risks actually faced by many banks, and are distorting incentives for banks regarding the capital maintained for a given level of risk. In the context of preventing and managing financial crisis, there is widespread agreement that better control over international interbank lending in source countries could contribute to greater global financial stability. However, while the short-term exposure of international banks has been a major feature of recent external debt crises, the Basle Capital Accord attributes a low (20 per cent) risk weight for the purpose of calculation of capital requirements to claims on banks outside the OECD area with a residual maturity of up to one year and all claims on banks incorporated in the OECD area. Such perceptions of flaws in the existing Accord have led to pressure for regulatory changes, and underlie the new initiative of the Basle Committee on Banking Supervision for its reform.<sup>16</sup> The approach now envisaged rests on “three pillars”: minimum capital requirements, supervisory review of capital adequacy in accordance with specified qualitative principles, and market discipline based on the provision of reliable and timely information (discussed in paras. 10-11 above). The new proposed capital rules include provision for risk weights for exposure to sovereign entities based on the assessment of eligible institutions providing this service and two possible approaches to weights for interbank exposures, one linking them to the sovereign risk for the country where the bank is incorporated and the other using the ratings of eligible assessment institutions. Either approach would be likely to lead to widespread increases in the capital requirements for interbank lending.

## **2. A world financial authority**

22. The increasingly global character of financial markets and growing links between different categories of financial business have given rise to proposals for the creation of a global mega-agency for financial regulation and supervision or world financial authority (WFA). These proposals would appear to be motivated by two arguments. According to one argument, since financial businesses are becoming increasingly interrelated and cross-border, their regulation and supervision should also be carried out on a unified and global basis. The other argument transcends the usual regulatory and supervisory issues and focuses instead on the stability of capital movements under the present patchwork of regimes which only more globally uniform regulation could be expected to control. Various models for a WFA can be envisaged, spanning the spectrum from an institution built on (and thus involving a limited departure from) existing arrangements to one with more comprehensive responsibilities.

23. While there is considerable scope for strengthening both national regulatory regimes and improving cooperation between national supervisors, it is not clear that the more ambitious variant would be a better instrument for this purpose than improvements in the functioning of institutions and modalities already in existence. Such a WFA would have to confront the problem of reconciling and integrating the different legal and conceptual frameworks under which supervisors from different backgrounds work. Furthermore, there are no compelling reasons to believe that such a WFA would be more successful than IMF in achieving stability in currency markets and capital flows. The legal instruments on the basis of which the WFA operated would have to be reconciled with the powers of existing institutions, notably IMF. There is also the matter of how power would be exercised in the new institution and by whom. It is not realistic to envisage that a global institution like a WFA with genuine clout could be established on the basis of a distribution of power markedly different from that of existing multilateral financial institutions. The alternative to a WFA is not an institutional tabula rasa. A network of institutions, albeit imperfect, is already in place, and there can be potential

benefits from strengthening it, and extending its mandate in certain areas as greater participation is assured and its governance improved.

### 3. Limits of prudential regulation

24. The continuing incidence of financial instability and crises in industrialized countries suggests that regulatory and supervisory reform is unlikely to provide fail-safe protection in this area. If this statement is true even of countries with state-of-the-art financial regulation and supervision, it is likely to apply a fortiori to most developing and transition economies. These limits to the effectiveness of regulation and supervision have various sources. First, financial regulation is constantly struggling to keep up with financial innovation, and in this struggle it is not always successful. Closely related in many ways to financial innovation are increased difficulties regarding the transparency required for regulation and supervision. Moreover, as described in section C above, the balance sheets and other financial statements of many financial firms have an increasingly chameleon-like quality which reduces their value to regulators.

25. Yet perhaps the most fundamental determinant of the limits of regulation and supervision is the susceptibility of most assets of banks to changes in their quality resulting from changes in economic conditions. No loan or other asset issued by a private sector entity on a bank's balance sheet should be classified generically as good. However reasonable the original managerial decision to make a loan or acquire an asset, and however justified its initial classification as low-risk by banking supervisors, the loan is vulnerable to a possible eventual deterioration in its status.<sup>17</sup> So long as cycles of financial boom and bust are features of the economic system, so also will be unforeseeable deteriorations in the status of many bank assets. Eventually, the effects of excess capacity generated by a boom and of the overextended position of financial firms are likely to combine with the factors such as those described in the introduction to this section to transform that boom into a movement in the opposite direction. The limits on the crisis-preventing potential of financial regulation are generally recognized by specialists in the field, so that its primary objectives are regarded as having more to do with reducing financial firms' liquidity and solvency problems, protecting depositors, and preventing or mitigating systemic risks due to contagion.

## E. Policy surveillance

26. In view of the growing size and integration of financial markets, every major financial crisis now has global ramifications. Consequently, preventing a crisis is a concern not only for the country immediately affected but also for other countries. Since macroeconomic and financial policies have a major role in the build-up of financial fragility and the emergence of financial crises, global surveillance of national policies is called for. IMF conducts bilateral surveillance of individual countries' policies through annual Article IV consultations and multilateral surveillance through periodic reviews of global economic conditions in the context of the *World Economic Outlook*. The failure of IMF surveillance in preventing international financial crises reflects, in part, belated, and so far only partial, adaptation of existing procedures to the problems posed by the large autonomous private capital flows; but perhaps more fundamentally that failure is due to the unbalanced nature of these procedures, which give too little recognition to the disproportionately large global impact of monetary policies in a small minority of OECD countries.

27. Even though the IMF surveillance, as formally defined, is limited to exchange-rate policies, its scope has tended to broaden over time, so that it now encompasses "all the

policies that affect trade, capital movements, external adjustment, and the effective functioning of the international monetary system”.<sup>18</sup> Given the degree of global interdependence, a stable system of exchange rates and payments positions calls for a minimum degree of coherence among the macroeconomic policies of major industrialized countries subject to the proviso that this quest should not lead to a deflationary bias in policies, since, as stated by IMF Article of Agreement IV, the ultimate objective of policy should be to foster “orderly economic growth with reasonable price stability” (sect. 1 (i)). The existing modalities of IMF surveillance do not include ways of attaining such coherence or dealing with unidirectional impulses resulting from changes in the monetary and exchange-rate policies of the United States of America and other major OECD countries.

28. The need for strengthening IMF surveillance in response to conditions produced by greater global financial integration and recurrent crises was recognized by the Interim Committee in April 1998.<sup>19</sup> However, despite the reference to interdependence, it is not evident that these proposals extend to weaknesses arising from the lack of balance in existing procedures. Moreover, even within the current limits of surveillance, the record of diagnosis of build-up of financial fragility and external vulnerability is not satisfactory. After the Mexican crisis, the list of developments that may trigger discussions between the Fund and a member country under IMF surveillance of exchange-rate policies was extended to include “unsustainable flows of private capital”,<sup>20</sup> but this did not prevent the East Asian crisis.

29. In future, surveillance will need to pay greater attention to unsustainable exchange-rate and payments developments caused by capital inflows, and the Fund’s recommendations should include, where needed, control over such inflows. This is consistent with the original IMF mandate on surveillance over exchange-rate policies. Given the difficulties in identifying factors likely to cause financial crises, it may be more prudent to place greater reliance as a matter of course on capital controls and other measures at the national level directed at external assets and liabilities. The effectiveness of IMF surveillance will also depend on the reform of the Fund and its governance structures so as to ensure increased transparency, accountability and greater participation by developing countries.

## **F. An international lender of last resort**

30. There have been calls to establish an international lender-of-last-resort facility in order to provide international liquidity to countries facing financial panic and to support their currencies. Provision of liquidity to pre-empt large currency swings has not been the international policy response to currency crises in developing countries. Rather, assistance coordinated by IMF has usually come after the collapse of the currency, in the form of bailout operations designed to meet the demands of creditors, to maintain capital-account convertibility and to prevent default. Moreover, availability of such financing has been associated with policy conditionality that at times went beyond macroeconomic adjustment. Such bailout operations pose a number of problems. First, they protect creditors from bearing the full costs of poor lending decisions, thereby putting the burden on debtors. Moreover, they create moral hazard for international lenders and investors, encouraging imprudent lending practices. Finally, they require increasingly large amounts of financing which have been difficult to raise. These problems would not be altogether avoided by creating a genuine international lender of last resort. The effective functioning of such a lender depends on two conditions: it should have the discretion to create its own liquidity (or to have unconstrained access to international liquidity), and there should be reasonably well-defined rules and conditions that the borrower must meet.

31. Strictly speaking, IMF does not satisfy either of the above conditions for qualification as a lender of last resort. The Supplemental Reserve Facility (SRF), approved by the IMF's Executive Board in response to the deepening of the East Asian crisis in December 1997, provides financing without limit to countries experiencing exceptional payments difficulties but under a highly conditional Standby or Extended Arrangement. However, SRF would depend on the existing resources of the Fund which, recent experience suggests, are likely to be inadequate on their own to meet the costs of bailouts.<sup>21</sup> The creation of the Contingency Credit Lines (CCL) in April is intended to provide a precautionary line of defence in the form of short-term financing which would be available to meet balance-of-payments problems arising from international financial contagion.<sup>22</sup> The pressures on the capital account and international reserves of a qualifying country must result from a sudden loss of confidence among investors triggered largely by external factors. Its availability is subject to the country's compliance with conditions related to macroeconomic and external financial indicators and with international standards in areas such as transparency, banking supervision and the quality of its relations and financing arrangements with the private sector. The hope is that the precautionary nature of CCL will restrict the level of actual drawings but, although no limits on the scale of available funds are specified, like SRF, CCL will depend on the existing resources of the Fund.

32. The special drawing rights (SDR) might play a key role in the creation of a lender-of-last-resort facility; but this would probably require an amendment of the IMF Articles of Agreement and could face opposition from some major industrialized countries. Even if one were to agree that IMF could act as an international lender of last resort but without such a capability to create its own liquidity, the Fund would still require access to adequate resources. Since there is agreement that IMF should remain largely a quota-based institution, funding through bond issues is ruled out. This leaves the Fund's own resources and borrowing facilities as the only potential sources of funding. However, they alone could not provide financing on the scale made available by IMF and other sources during the Mexican and East Asian crises. Moreover, the terms of access to an IMF facility for this purpose pose additional problems. The conditions of lender-of-last-resort financing, namely, lending in unlimited amounts and without conditions except for penalty rates, would require much tightened global supervision over borrowers to ensure their solvency, an unlikely development. While automatic access would ensure a timely response to market pressures, it would also create moral hazard for international borrowers and lenders and considerable risk for IMF. By contrast, conditional withdrawal of financial support would reduce the risk of moral hazard, but negotiations could cause long delays, and could also lead to unnecessarily tough conditionality.

33. One way of avoiding these problems might be through pre-qualification: countries meeting certain *ex ante* conditions would be eligible for lender-of-last-resort financing, with eligibility being determined during Article IV consultations. However, pre-qualification involves its own set of problems. First, IMF would have to act like a credit-rating agency. Second, the result could be a further segmentation of the Fund's membership, with attendant consequences for its governance. Third, lending at penalty rates might not be enough to avoid moral hazard. Finally, it would be necessary to constantly monitor the fulfilment of the terms of the financing, adjusting them as necessary in response to changes in conditions. Here difficulties may emerge in relations between the Fund and the member concerned.

34. Another critical issue is that establishing a genuine international lender of last resort would imply a fundamental departure from the underlying premises of the Bretton Woods system which provided for the use of capital controls to deal with capital flows. In discussion of such a facility, its introduction is frequently linked to concomitant arrangements regarding rights and obligations with respect to international capital transactions, together with a basic commitment to capital-account liberalization. Even if a properly functioning international

lender of last resort could be put in place, it is not clear that this would be the right course of action for developing countries.

## G. Orderly debt workouts

35. Commenting on the debt crisis of the 1980s more than a decade ago, UNCTAD pointed to the circumstance that debtor countries often had to face at one and the same time “the financial and economic stigma of being judged *de facto* bankrupt, with all the consequences that this entails as regards creditworthiness and future access to financing, (while also largely lacking) the benefits of receiving the financial relief and financial reorganization that would accompany *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code”.<sup>23</sup> Chapter 11 procedures are especially relevant to international debt crises resulting from liquidity problems. Debtors are usually left in possession of their property, and the aim of the procedures is to facilitate orderly workouts in three stages. At the outset, procedures allow for an automatic standstill on debt servicing. This prevents a “grab race” for assets by creditors, allows the debtor the opportunity to formulate a reorganization plan, and ensures that creditors are treated equally. Second, the Code provides the debtor with access to working capital needed to carry out its operations. The final stage is the reorganization of assets and liabilities of the debtor and its operations. The Code discourages holdouts by a certain class of creditors. For solvent but illiquid firms, automatic stay and access to new financing may need to be supplemented with an extension of debt maturities. Insolvent firms, on the other hand, would require debt write-downs and conversions, reorganizations and, where solvency cannot be restored through such means, liquidation. These procedures are used not only for private debt. Chapter 9 of the Code applies the same principles to public debtors (municipalities). Similar arrangements exist in most other industrialized countries.

36. The application of such principles to cross-border debt involves a number of complex issues. What is under consideration here are systemic illiquidity problems associated with a generalized rush to exits and a run on the currency. Individual debtors may enjoy insolvency protection subject to provisions in their contracts with the creditors. However, while helpful, such provisions do not offer much relief to a country facing generalized debt and currency runs, even if the bulk of the external debt is owed by private banks and firms. When there are numerous debtors, it is very difficult to activate appropriate procedures simultaneously for all so as to halt the run on the currency. More importantly, as in East Asia, most private debtors may indeed be solvent, but the country may not have the reserves to meet the demand for foreign exchange. However, currency runs can make such debtors insolvent.

37. Current judicial practices and government policies in the major industrialized countries do not allow debtor Governments to benefit from standstill provisions regarding their external debt. In practice, Governments are reluctant to resort to unilateral suspension of debt servicing and exchange controls, even in the extreme event of financial panic. In view of the deficiencies of current institutional arrangements, there is now a growing recognition of the need for reform. One proposal is to create an international bankruptcy court in order to apply an international version of chapter 11 (or chapter 9) drawn up in the form of an international treaty ratified by all States Members of the United Nations. A less ambitious and perhaps more feasible option would be to establish a framework for the application to international debtors of the key insolvency principles mentioned above.

38. In one view, under such a framework standstills would need to be sanctioned by IMF. The Canadian Government has gone further, proposing an emergency standstill clause to be mandated by IMF members.<sup>24</sup> However, it would be difficult to avoid delays and panics in any

procedure requiring prior consultations with the Fund. Moreover, there may be a problem of conflict of interest. It has been argued that the Executive Board of IMF is not a neutral body which could be expected to act as an independent arbiter because countries affected by its decisions are also among its shareholders. An alternative procedure would thus be to allow countries meeting certain *ex ante* criteria during Article IV consultations to have the right to impose standstills, should their currencies come under attack. While such a procedure would suffer from drawbacks analogous to those discussed in section F above in connection with the proposal for pre-qualification for lender-of-last-resort financing from IMF, it would be superior to a procedure requiring negotiations with IMF during the unfolding of a currency crisis.

39. Under another alternative, which avoids the objections to procedures involving sanction by IMF, the decision for standstill could be taken unilaterally by the debtor country and then submitted to an independent panel for approval within a specified period. Its ruling would need to have legal force in national courts for the debtor to enjoy insolvency protection. If they are to have the desired effect on currency stability, debt standstills should be accompanied by temporary exchange controls over all capital-account transactions. There would also be a need to combine debt standstills with debtor-in-possession financing. This would mean IMF "lending into arrears". Legally sanctioned standstills would facilitate debt restructuring negotiations. For sovereign debt to private creditors, reorganization could be carried out through negotiations with the creditors, and IMF could be expected to continue to play an important role by providing a forum for negotiations. For private debtors, government involvement in negotiations would be inevitable when the stability of the domestic banking system was at stake. In past episodes of crisis, negotiated settlements often resulted in the socialization of private debt. Such practices are not consistent with bankruptcy principles. In the restructuring negotiations, judicial procedures could be applied to individual debtors according to the law and the forum governing the contracts at issue.

40. Writing such a standstill mechanism into the rules and conditions governing international financial contracts means that lenders and investors would know in advance that they might be locked in, should a country's currency come under attack. This should promote a better assessment of risks, eliminate moral hazard and reduce purely speculative short-term capital flows to emerging markets. It would also remove the need for large-scale bailouts.

## IV. Conclusions

41. Given the inherent instability of international capital movements, recent experience shows that any country closely integrated into the global financial system is susceptible to financial crises and currency turmoil. Developing countries are particularly vulnerable owing to their dependence on foreign capital and their net external indebtedness.

42. In an ideal world, global arrangements designed for the prevention and management of financial instability and crises would include (a) some combination of improved disclosure and transparency by both public and private institutions; (b) effective surveillance over national macroeconomic and financial policies; (c) globally agreed but nationally implemented rules for the control of capital flows through oversight of international lenders and borrowers; (d) an international lender of last resort with discretion to create its own liquidity; and (e) orderly debt workout procedures in international finance. The case for improved disclosure and transparency and strengthened financial regulation and supervision is now widely accepted, although the potential benefits from such improvements are probably exaggerated. On the other hand, there is resistance to strengthened multilateral surveillance over the monetary

and exchange-rate policies of the major industrialized countries and to global rules regarding international capital movements. There is also unwillingness to establish a genuine international lender of last resort. Instead, efforts are being focused on piecemeal increases in the availability of external financing (with its attendant discipline on debtor countries), more orderly debt workout procedures, and involvement of the private sector in the resolution of financial crises.

43. Developing countries would benefit from a more flexible approach that embodied the principle of national control over capital flows together with internationally agreed arrangements for debt standstills and lending into arrears. In particular, the autonomy of developing countries in managing capital flows and choosing their capital-account regimes should not be constrained by international agreements on capital-account convertibility, international investment or trade in financial services.

### Notes

<sup>1</sup> For the definition of capital inflow, see note to table 1.

<sup>2</sup> For a detailed analysis of these trends in capital inflows to developing countries, see *Trade and Development Report, 1999* (United Nations publication, Sales No. E.99.II.D.1), chap. V, sect. D.

<sup>3</sup> Concerning the estimates and forecasts of these different bodies, see note to table 2.

<sup>4</sup> A large part of the fluctuation for East and South Asian economies is due to net private capital flows to Indonesia, Malaysia, the Republic of Korea, the Philippines and Thailand.

<sup>5</sup> For further details see *Trade and Development Report, 1998* (United Nations publication, Sales No. E.98.II.D.6), part one, chap. III, annex.

<sup>6</sup> Dollarization adds further to vulnerability since it effectively eliminates the difference between residents and non-residents in the determination of the profitability of their investments and their ease of access to foreign assets.

<sup>7</sup> These issues are also treated in the report of the Task Force of the United Nations Executive Committee on Economic and Social Affairs entitled *Towards a New International Financial Architecture*.

<sup>8</sup> See, for example, the reports of the Working Group (of the Group of 22) on Transparency and Accountability, mimeograph, October 1998.

<sup>9</sup> See Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Basle, 1997), p. 37.

<sup>10</sup> See Bank for International Settlements, *Public Disclosure of Market and Credit Risk by Financial Intermediaries*, a discussion paper proposed by a Working Group of the Eurocurrency Standing Committee of the Group of Ten Countries (Basle, September 1994), para. 2.4.

<sup>11</sup> See the remarks of William McDonough, President of the Federal Reserve Bank of New York and current Chairman of the Basle Committee on Banking Supervision, in J. A. Leach and others "Global derivatives: public sector responses", Occasional Paper, No. 44 (Washington, D.C., Group of Thirty, 1994).

<sup>12</sup> For recommendations as to best practice, see Basle Committee on Banking Supervision, *Enhancing Bank Transparency: Public Disclosure and Supervisory Information that Promote Safety and Soundness in Banking Systems* (Basle, September 1998).

<sup>13</sup> In some countries, there may also be divergence between the enunciated standards of the regime for accounting and financial reporting and the actual practice of several financial firms. For more detailed discussion of these surveys, see A. Cornford, "Standards for transparency and banking regulation and supervision: contrasts and potential", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. XI (forthcoming).

<sup>14</sup> See T. E. Krayenbuehl, *Country Risk: Assessment and Monitoring*, 2nd ed. (Cambridge, United Kingdom, Woodhead Faulkner, 1988), parts two and three; and J. B. Caouette, E. I. Altman and P. Narayanan, *Managing Credit Risk: The Next Great Financial Challenge* (New York, John Wiley, 1998), chap. 22.

- <sup>15</sup> Credit risk results from the possibility that a bank's counterparty will default on its obligations, and market risk is the risk of loss due to changes in the market value of a bank's asset before it can be liquidated or offset in some way.
- <sup>16</sup> See *A New Capital Adequacy Framework*, consultative paper issued by the Basle Committee on Banking Supervision (Basle, June 1999).
- <sup>17</sup> See *Trade and Development Report, 1998 ...*, part one, chap. IV, sect. C.3.
- <sup>18</sup> Group of Ten, "The functioning of the international monetary system", a report to the Ministers and Governors by the Group of Deputies (Washington, D.C., June 1985), para. 40.
- <sup>19</sup> Interim Committee communiqué of 16 April 1998.
- <sup>20</sup> IMF Executive Board Decision No. 10950-(95/37) of 10 April 1995 (amending Decision No. 5392-(77/63) of 29 April 1977).
- <sup>21</sup> See "IMF approves Supplemental Reserve Facility", *IMF Survey*, 12 January 1998, p. 7.
- <sup>22</sup> See *IMF Press Release No. 99/14*, 25 April 1999.
- <sup>23</sup> *Trade and Development Report, 1986* (United Nations publication, Sales No. E.86.II.D.5), chap. VI, annex.
- <sup>24</sup> Department of Finance, "Canada's Six Point Plan to Restore Confidence and Sustain Growth", September 1998.
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