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

Global financial flows and their impact on developing countries: addressing the matter of volatility

Report of the Secretary-General

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I. Introduction

1. A number of developing countries, mainly in Asia and Latin America, became increasingly successful in the early 1990s in accessing international financial markets. The extent of Latin American access was especially noteworthy, as the region had been largely bypassed by international financial investors in the 1980s, owing to the debt crisis. However, 1994 ended with a currency crisis in Mexico, followed in early 1995 by a crisis in Argentina and pressures on the financial and currency markets of several countries. By the summer of 1995, Mexico and Argentina were in deep adjustment recessions and the international community began to formulate policy measures to deal with a new class of crises, ones in which increasingly open developing and transition economies suddenly found themselves having to cope with large movements of financial flows.[1]

2. In the light of these experiences, the General Assembly began a series of discussions on development and global financial integration. These discussions led to the adoption of Assembly resolutions 50/91, 51/166 and 52/180 in 1995, 1996 and 1997 respectively.

3. As reflected in those resolutions, the international community updated its strategy for dealing with economic and financial crises in developing countries (for example, through improved standards of information flow to the public on emerging market economies and establishment of an emergency financing mechanism at the International Monetary Fund (IMF)). In addition, the Latin American crisis countries entered into recovery paths. Concern remained, however, about the degree of exposure to potential financial volatility.

4. Indeed, in July 1997 an economic crisis erupted in South-East Asia when Thailand was no longer able to maintain the fixed exchange rate of the baht. The updated international strategy for dealing with such situations was applied in assisting Thailand, the Philippines and then Indonesia (Malaysia was also heavily affected, but did not arrange an internationally supported adjustment programme). Beginning in October 1997, moreover, the nervousness spawned by the South-East Asian situation spilled over into financial and currency market volatility in Hong Kong, China; Brazil; South Africa; the Russian Federation and elsewhere. Even the New York Stock Exchange was affected for a time. The year ended with the Republic of Korea engulfed in a major financial crisis and a growing international chorus of questioning whether the new strategy was working.[2]

5. The General Assembly thus requested the Secretariat to analyse current trends in global financial flows and the effect of their volatility on growth and development, and to recommend ways and means to address the volatility of those flows (see Assembly resolution 52/180, para. 13). An assessment of the financial and economic situation of the affected countries as seen in April 1998 was presented in *World Economic and Social Survey, 1998*,[3] which, as requested, also offered a set of observations on policy for consideration by the Assembly. An updated assessment, as requested, was presented in *Trade and Development Report, 1998*,[4] with further policy considerations.

6. In addition, the General Assembly requested the Secretariat to prepare a report for the present session of the Assembly covering matters raised in Assembly resolution 52/180 (see para. 14 of that resolution). As other documentation prepared for this session of the Assembly under agenda item 91 reviews trends and policy issues concerning the financial flows and net transfers of resources of developing countries (see A/53/228) and the external debt situation of developing countries (see A/53/373), the present report focuses on suggested policy measures for national Governments and for strengthened international cooperation in the context of increasingly volatile international financial flows.

II. Towards a new consensus

7. Almost a decade ago, John Williamson, a British economist, coined the phrase "Washington consensus" to describe a set of policies that IMF, the World Bank and the Governments of various aid-giving countries had been jointly advocating for economic management and growth of developing countries, and for the effective insertion of these countries into the globalizing world economy.[5] Other international institutions – notably several members of the United Nations family – focused international attention more explicitly on the "human" dimension, environmental concerns and other aspects of the development of nations, but the Washington consensus was never seriously challenged in the realm of the "hard" policy concerns of macroeconomic stabilization and adjustment, trade and financial liberalization, until recently.

8. The change came as a result of the severity and duration of the Asian currency crisis of 1997–1998. Policy advice that was guided by the Washington consensus was unable to stem the economic decline in East Asia or protect distant countries from contagion. The economies of developing countries that had once been considered among the most successful and worthy of emulation were brought down low. The Asian miracle became the Asian crisis. Crisis management by national officials and the Bretton Woods institutions has thus

been challenged in a chorus of growing numbers and intensity, including legislators, academic critics and the financial and business community in major developed economies.

9. Under this wave of criticism and the unrelenting economic decline in the Asian crisis countries, internationally advocated policies have slowly changed. Fiscal and monetary policy conditions have been eased in the more recent adjustment agreements that crisis countries have struck with IMF,[6] and the time-frame for reaching the goal of complete capital account liberalization has been repeatedly lengthened and now stretches to upward of 50 years, at least for some countries.[7] Moreover, in April 1998, the Institute of International Finance (IIF), which reflects the views of the major international commercial banks that are its members, sent a letter to the Interim Committee of IMF, *inter alia*, expressing reservations about amending the IMF's Articles of Agreement to make capital account liberalization a main goal of the Fund.[8]

10. One strength of the multilateral institutions over the past 50 years has been their capacity to learn and adapt, which this year has required a period of reflection and study.[9] Indeed, thinkers from all corners of the world have been analysing and discussing recent developments for over one year. It thus seemed timely to see if a new consensus was emerging on policy for macroeconomic management and growth and for effective integration into the global financial system. A meeting to take stock was therefore held in July comprising individuals from many parts of the United Nations, IMF, the World Bank, other international institutions, the private sector and academia, who have grappled with these policy concerns.[10] The coalescing of views that seemed to emerge from this meeting was less a break with the Washington consensus than a pragmatic modification, in the light of recent experience, of some aspects of it .

The political art of policy-making

11. The first element of the new consensus may set the tone for the discussion to follow. It entails the awareness that policy-making is carried out in a political context, and policy prescriptions must be politically viable. Thus, policy formulas developed for one set of national institutions do not automatically work well in others; institutions developed for one period can become inappropriate in later ones. The art of policy-making consists in recognizing when change is necessary in policies and/or institutions, when change is possible, and how change can be brought about effectively.

12. The choice of policies and measures involves a wide range of considerations and frequently will not be optimal from a purely technical point of view, even in those circumstances where there is agreement on what is optimal. Moreover, there is a fine line between policies that are suboptimal but tolerable and policies that are unsustainable. To the degree that a country is open to international financial movements – and no country is completely closed – incomplete (or even erroneous) "news" about the economy can move perceptions across the line and turn what is seen as a policy flaw into a policy disaster.

13. Therefore, institutions need to be sufficiently robust to withstand the consequences of perceptions of policy shortcomings; in particular, loss of confidence of short-term investors should not threaten economic collapse. Institutions must also be in place before they can be drawn upon; for example, the time to weave a social safety net is before there is a crisis. In addition, sometimes the appearance of institutional change will exceed what is actually achieved; for example, privatizing state enterprises need not by itself produce the expected economic restructuring or competition. Continued monitoring is essential, and this requires provision and dissemination of reliable and appropriate data, and vigorous public discussion of policy and institutional concerns.

14. The new consensus, moreover, is well aware that the international institutions that stand behind their policy advisers may offer "carrots" or "sticks" to prod policy reform, but that in the end it is only the Government that implements any policy decision. International observers should not expect more from a policy dialogue between a Government and an international institution than is realistic.

15. This notwithstanding, there is widespread recognition that international policy advisers can take on unusually powerful roles during economic crises. At such times, they need to be particularly sensitive to local conditions. For example, in a country emerging from years of civil conflict, priorities normally accorded to fiscal adjustment have to be weighed against programmes to build confidence in government and development. This could affect the assessment of the government's debt-servicing capacity and foreign assistance requirements. Or, to take another example, potentially viable firms may easily be lost in the middle of a financial crisis. As their reconstitution may be far from automatic or quick, the economic and social consequences can be long-lasting. Debt workouts in such cases might be considered part of the policy dialogue. In such situations in particular, international policy advisers act on behalf of the broadest interests of the international community and need to be particularly sensitive to social and structural fragility.

Macroeconomic policy in capital-importing countries

16. Macroeconomic policy-making – always difficult – is made even more complex when capital markets are open and financial flows are volatile. As a practical matter, macro-policy should thus aim to attain medium-term goals and incorporate automatic stabilizers to help absorb short-term fluctuations (for example, stabilization funds can even out the tax revenues from unstable earnings on commodity exports).

17. As a general rule, in order to smooth the growth of aggregate demand, fiscal policy should tend to offset private spending booms that may accompany strong financial inflows, and vice versa during outflows. Medium-term budgeting with built-in plans to accelerate or slow certain outlays as needed might mitigate the political difficulty of cutting discretionary spending during periods of strong growth when there is no crisis to be seen. Operationally, the budgetary policy target should be the "structural" balance, which takes account of the impact of cyclical developments on the budgetary outcome, rather than the nominal balance.[11]

18. The ability to use monetary policy for domestic stabilization purposes is inseparable from the choice of exchange-rate regime. Typically, monetary policy is one of the policy tools for managing the balance of payments. For example, increases in domestic interest rates may be called upon to stem an unwanted financial outflow. This may be effective, but it is a dangerous policy choice when the domestic financial sector is weak and the level of debt in the economy is high. An increase in domestic interest rates has a psychological effect as well as a financial impact on firms and financial institutions and so must be a credible signal of government commitment to a tight policy stance. If the economy cannot withstand the shock (as was the case in certain Asian economies in 1997), the signal is unlikely to have the desired impact and may even have the obverse one.

19. Financial outflows from a country may reflect a loss of confidence in the local economy. Sometimes they can be triggered by unrelated developments elsewhere. Certain macroeconomic indicators, such as an increasing difference between domestic and foreign interest rates, a falling ratio of official foreign reserves to the money supply, a high share of short-term financing in external capital inflows, or a rising ratio of current-account deficit to gross domestic product (GDP), may be monitored for signs of an approaching unsustainable situation. However, there are no universally applicable rules or "standards" regarding the critical level of such indicators. Confidence may be lost at different values of the indicators for different countries or at different times for a single country. Decisions of the private sector to move money in or out of a currency are matters of judgement in an uncertain situation subject to dramatic changes.

20. One such dramatic change occurs when a "pegged" or fixed exchange rate becomes unsustainable and has to undergo a discrete adjustment. An alternative is to allow some flexibility in the exchange rate so that smaller, daily changes prevent the build-up of pressure for a large change. The problem is that the inherent volatility of financial flows may make the daily changes excessively large. For such reasons, some form of controlled flexibility can be attractive. For example, a thoughtfully designed "crawling peg" can stop the real exchange rate from appreciating, the trade balance from widening and the expectation of a significant devaluation from growing.[12]

21. The crucial issue is to avoid creating a situation of "one-way bets" for speculators in which a Government endeavours to maintain an exchange rate that is widely perceived to be overvalued. Under such circumstances, currency traders will usually be able to mobilize more financial resources than the Government and will force a devaluation by selling more local currency than the Government can buy.[13] While controls on short-term capital movements can limit such possibilities, controls become harder to enforce as the profit expected from evading them rises. The expected profits can be held down by allowing exchange rates to be changed before speculative pressures build. On the other hand, flexible exchange rates call for the development of forward markets or markets in "futures" securities that enable firms to reduce their exchange-rate risks.[14] In any event, the fact that forward and futures markets for the currencies of most developing countries are likely to be relatively thin reduces the attractiveness of freely floating exchange rates.

22. A common compromise is to allow flexibility within a band around a given exchange-rate peg. For this to work, however, the authorities must keep the exchange rate well within the band; if the value of the currency approaches the edge of the band, speculative pressures can build, as in the case of a strictly fixed exchange rate. A more sophisticated approach would be a combination of periodic changes in the central rate to compensate for differences in inflation with trading partners, combined with intermittent and irregular central-bank intervention in the market to raise uncertainty about the size and direction of short-term movements in the exchange rate (that is to say, "vigorous dirty floating"). If this strategy exceeds the resources and capabilities of the central bank, the authorities may have to choose between accepting

vulnerability to potentially sharp fluctuations in the exchange rate and using some controls on capital movements to strengthen the hand of the central bank.

Speed and sequencing of financial liberalization

23. Relaxation of policy limitations on a domestic financial sector should not be carried to the point of complete laissez-faire. That financial institutions are inherently prone to excess and vulnerable to crisis warrants appropriate supervision and prudential regulation. By the same token, liberalizing international capital flows opens an economy not only to important opportunities, but also to additional volatility which could present dangerous challenges, especially for small economies in which the external financial flows might grow to a significant share of GDP.

24. It thus seems generally preferable to develop and locally deregulate the different elements of domestic financial markets before opening them externally.[15] The top priority should be to build a robust banking system. The development of stock exchanges has also been given priority in many countries, but next to the banking system and the potential benefits of domestic bond markets, stock markets are of relatively marginal importance for development, especially for the development of small and low-income economies in the early stages of financial development.

25. Foreign direct investment (FDI) can be an especially fruitful form of financial inflow, which is why it is often encouraged as one of the first components of capital inflow to be liberalized. Although it is typical to think of the benefits that can be brought by large multinational corporations, small and medium-sized companies can also offer important opportunities in transborder investing.

26. However, FDI is not a panacea and total flows should be monitored; for example, a surge in FDI inflows can overvalue a currency's exchange rate as much as any other type of international finance. Also given the physical presence of direct investors from foreign countries, there is a possibility of broad resentment and political backlash. This could be the case, for example, if it were deemed that substantial amounts of local corporate assets had been acquired by foreign firms at distress-sale prices owing to a crisis. More generally, as FDI is not an undifferentiated financial flow but investment in a sector-specific activity, policy makers have to ensure its consistency with national development strategies and social and environmental priorities.

27. The most difficult issue in financial liberalization is choosing which flows to deregulate and which to control at any point in time. Much of the blame for the Asian financial crisis is commonly attributed to the untimely and poorly sequenced liberalization of financial movements. In light of the above discussion on exchange rate management, some form of impediment to volatile financial flows seems warranted in most developing countries. However, it is not a simple matter to separate volatile flows from the long-run investments that should be encouraged; as an example, even funds brought into a country by a direct investor can be used to take a speculative position in a currency.

28. In this regard, there has been considerable interest in policy experiments that use broad, market-based measures rather than selective administrative restrictions to discourage financial volatility. The Chilean effort to limit vulnerability to speculative outflows by limiting speculative inflows is the best known in this class of policy measures. In the context of its highly open economy, Chile adopted a combination of financial and quantitative controls on external flows. Most attention has focused on the requirement that financial investors sequester a fraction of their capital inflow with the central bank at no interest for one year (even if the funds are removed in less than one year).[16] While this technique appears to have limited speculative inflows initially, it was increasingly evaded. In 1996, when international demand for Chilean investments was especially strong, the sequestering requirement appeared to serve in effect as the willingly paid price of entry into the Chilean stock market. Moreover, in 1998, with Chile's stock market and currency heavily impacted by the economic fallout of the Asian crisis, the policy was substantially eased so as to be less of a barrier to capital inflows.

29. The lesson of the Chilean experience – like the lesson of countries with stringent administrative controls – is that controls can be evaded and are more likely to be evaded the greater the financial incentives for such evasion. On the one hand, this means that the exchange rate should not be allowed to become clearly unsustainable because the incentive to evade the controls is thereby increased. On the other hand, it means that the instruments of control need to be strengthened as weaknesses and loopholes appear. In addition, the degree of restrictiveness of the controls needs to be relaxed when conditions warrant, in other words, controls should be a flexible instrument of policy. Moreover, non-discretionary and semi-automatic instruments will be less susceptible to corruption and evasion. All in all, countries that seek to manage their foreign exchange market should have a battery of policy instruments available, rather than try to rely on a single policy tool.

Quality of regulation in capital-importing countries

30. As a matter of accounting, external imbalances have internal counterparts. However, to trace these adequately requires more information, and on a more timely basis, on aggregated domestic stocks as well as flows (for example, levels of debt in corporate as well as banking sectors, private liquidity ratios and debt/equity ratios, as well as borrowing flows). It is essential for the authorities to monitor the financial state of the domestic economy in order to identify and address unsustainable situations as they arise, and for this they may need new types of information.[17]

31. In many cases, this also means that the government should take measures to improve accounting and reporting by domestic businesses; such a step is important especially in countries seeking to develop domestic securities markets. Regarding banking per se, a compendium of supervisory documents has been produced by the Basle Committee on Banking Supervision, particularly the 1997 core principles for effective banking supervision.[18] This is only a step, however, as the integrated nature of finance requires a comprehensive supervisory framework that can provide a perspective on the financial sector as a whole, covering, in particular, banks, non-bank financial institutions, securities and insurance firms.

32. While inadequate regulation is a concern, weak enforcement of regulations is especially costly. One crucial issue here is how to manage what are called “non-performing assets”, not only the overall level but also the distribution by size of loan. In some cases – most dramatically, but not exclusively, in transition economies – lending officers in financial institutions, supervisors and regulators will need training to function adequately in a new environment of enterprise-bank relations and accountability. Local authorities must have the necessary resources and autonomy to carry out their responsibilities in this regard.

Policy in developed countries

33. Developing-country policy makers have to cope as best they can with the external economic environment as they find it. However, that environment is very much influenced by the policies and measures of developed countries, particularly the major-currency countries, both individual and collective. In mid-1998, for example, it was generally considered essential for the Government of Japan to address more effectively the problems besetting its economy, particularly its banking situation and need for a credible economic stimulus package, since this had been adversely affecting other countries, particularly other countries in crisis in the region.

34. In general, however, macroeconomic policy coordination among the world’s major economies has proved difficult, otherwise than in the occasional joint intervention in foreign exchange markets when policy makers together signal that they believe exchange-rate changes have become excessive. One reason for limited coordination is that different Governments have not always shared the same view of the essential driving forces in their economies or the same policy priorities.

35. The difference of views has been especially sharp in the case of the Japanese economy in recent years and can be seen in the efforts of partner countries to encourage policy changes in Japan. This experience suggests that a useful instrument for international coordination is vigorous international public debate on policy questions of global importance as a means to build a consensus on policy.

36. One area in which thinking in different official circles has been along relatively similar lines is that of the principles of financial market regulation and oversight. The financial volatility seen in Asian and other emerging-market economies in 1997 and 1998, however, suggests that some regulatory gaps remain in developed economies. A number of financial institutions in developed economies took excessively risky positions by accumulating large holdings of poor quality and poorly diversified foreign assets. Thus, in these countries, as well as in the emerging-market economies, regulatory systems and early warning mechanisms need to be strengthened.

37. The oversight begins at the level of the financial firm, where it is in the nature of the industry for individual loan officers and portfolio managers to have incentives to take risky, albeit potentially profitable positions. Financial firms thus need strong internal risk measurement and control systems to ensure that the sum of the activities of their managers individually does not expose the firm as a whole to excessive risk. Equally, risk managers should have the authority to override senior management if necessary in order to cut excessive exposures.

38. It might be assumed that financial enterprises would act on such principles independently, but regulatory authorities have instead found themselves pushing firms in this direction. Indeed, at the urging of some of the banks that developed sophisticated internal risk management systems, this has become the broad thrust of new banking regulation.[19] Among the questions begging for answers, however, is, How well or poorly did these systems work during the Asian crisis?[20]

There is also a question whether the established capital standards themselves are sufficiently strict and comparable for bank and non-bank financial institutions and for financial conglomerates that combine various categories of activities and may operate in several countries.[21]

International reform

39. The main avenues for international cooperation in the financial arena are IMF and the Bank for International Settlements (BIS). Forty-five central banks, several of which are independent institutions, are members of BIS, which is the locus of decision-making in the international coordination of financial regulation. BIS services a group of committees, including the Basle Committee, that are concerned with different aspects of international banking and that work increasingly closely with unaffiliated international associations concerned with non-bank components of the financial sector. These are ad hoc arrangements that arose in response to perceived needs, but they have been carried out at a high level of professional competence.

40. IMF undertakes a periodic review of global capital markets, and principles adopted in the BIS committees may be included by IMF in its surveillance of the financial sectors of individual developed and developing countries. This gives a degree of international oversight regarding implementation of the BIS regulations. Nevertheless, there are concerns whether this combination of technical work in BIS committees and implementation oversight by IMF is an adequate mechanism for global cooperation in financial sector supervision. Bringing new regulatory questions under international discussion, for example, depends on acceptance of the issue by one of the existing committees or establishment of a new ad hoc arrangement. Also, IMF surveillance of implementation is necessarily less intense than a peer review mechanism of regulators, such as might be undertaken among BIS-member banking authorities. In addition, the World Bank and regional development banks provide financial support and technical cooperation for financial sector reform (with capacity in the case of the World Bank recently bolstered by the creation of its Special Financial Operations Unit in February 1998).

41. Proposals to pull these various threads together more effectively range from establishing a new institution to enhancing the responsibilities of one or more of the existing institutions.[22] While no new structure of institutional reform commands wide support as yet, the Finance Ministers of the Group of Seven (G-7), the major industrialized countries, in their report to the G-7 Heads of State or Government in Birmingham saw "an urgent need for a system of multilateral surveillance of national financial, supervisory and regulatory systems (which) could encompass surveillance of such areas as banking and securities supervision, corporate governance, accounting and disclosure, and bankruptcy". The Ministers then asked "the relevant institutions to develop proposals on ways in which greater cooperation can be achieved, including options for institutional reform".[23]

42. There have also been proposals to supplement the overall surveillance role of IMF in macroeconomic and financial policy with surveillance at the regional level, most actively in Asia. Although originally conceived in the context of a proposed Asian Fund, a new cooperative surveillance arrangement has been established by the member countries of the Association of Southeast Asian Nations (ASEAN). Modelled on "the G-7 format with a distinct ASEAN character", the group envisages regular informal meetings of central bank and finance officials at deputy and ministerial level in which they would evaluate "potential economic and financial risks of Member Countries ... (and encourage) early action to minimize such risks".[24] The initiative is being assisted by the Asian Development Bank.

43. Peer review and surveillance at the regional level are likely to be more sensitive to local conditions and requirements and, by bringing a plurality of views into discussions of appropriate conditionality, enhance their political effectiveness. There was also a financial dimension to the ASEAN plan: a "cooperative financing arrangement" of mutually supplied funds would potentially supplement the resources of IMF and other international financial institutions in the adjustment programme of a member country. Quick disbursement of funds for financial crisis situations was also made part of the arrangement, in this case through the agreement to maintain an existing ASEAN swap arrangement. However, the extremely difficult situation into which most ASEAN nations have fallen since adopting this plan has rendered the financial cooperation dimensions almost moot for the moment. It has also meant that the absence of the Asian Fund is felt more strongly.

44. As a result, IMF remains the only institution with the mandate to deal with international financial crises. However, IMF resources have become strained by the demands imposed on them by the recent crises. If the international community wishes IMF to carry out the role it has been assigned, the agreement to increase its resources should be implemented without delay.[25]

45. This notwithstanding, the resources that IMF needs to deploy in any specific crisis depend in part on how the claims of private foreign lenders are treated. In the case of the

Republic of Korea, it became most clear that a considerable portion of the international official resources channelled to the Republic of Korea at the end of 1997 was helping to finance the retreat of foreign bank lenders. Even though international commercial banks are the arteries for monetary and payment systems and thus warrant special treatment, it was widely felt that they should have been required to roll over maturing loans and replace short-term credits with longer-term maturities; indeed, by early 1998, this was the approach adopted.[26]

46. There is considerable sentiment, especially among experts, in favour of international adoption of stronger proposals in the same vein. Conditions would be established under which debtor countries in balance-of-payments crisis would not be penalized for undertaking a "debt standstill", that is to say, a moratorium on debt servicing having at least implicit approval of the creditors.[27] The availability of such a mechanism could be made manifest before a crisis struck by writing into loan contracts that some potential event – perhaps validated by an international assessment of need – might trigger a warranted standstill. Knowledge that such a standstill might be declared would increase the perception of riskiness of bank lending to emerging-market economies, and this in turn could discourage excessive inflows. It would also probably slightly raise the cost of credit, as banks would bear more risk. Above all, however it would perforce "bail in" the private creditors that accepted being exposed to such situations: they would have every incentive to accept a "voluntary" debt restructuring should an emergency arise, rather than write off their loans.

47. A complementary proposal would further encourage creditor cooperation in restructuring the debt due in such circumstances. This proposal has come to be called "IMF lending into arrears". It would entail an IMF policy decision to permit agreement to a Fund-supported economic adjustment programme with a member country under certain circumstances even if arrears were continuing to accumulate on outstanding debt. If the debt standstill and "lending into arrears" were deployed together, these two options could make the difference in terms of maintaining adequate liquidity and avoiding the kind of credit crunch that seized up the financial systems of the Asian crisis countries.

III. Conclusion

48. This report is being submitted while we are still in the midst of the storm that has hit the global financial system. Hence, the outlines of the consensus on national and international policies for macroeconomic and financial management presented above must be considered an interim exercise. If the storm blows over soon, a widespread recession is avoided and the most affected economies resume the path of growth relatively quickly, then the new consensus presented above may be sufficient to reduce the risks of a similar episode in the future. If, however, the storm worsens, then the changes suggested by the new consensus may not be sufficient and the policy paradigm for development in a globalized market economy may need to be revised.

Notes

[1] Developments were traced in two reports of the Secretary-General, one entitled "Global financial integration: challenges and opportunities" (A/51/388) and the other "Global financial integration: an update" (A/52/406).

[2] For a variety of assessments presented to the General Assembly, see Barry Herman and Krishnan Sharma, eds., *International Finance and the Developing Countries in a Year in Crisis: 1997 Discussions at the United Nations* (Tokyo, United Nations University Press, 1998).

[3] United Nations publication, Sales No. E.98.II.C.1.

[4] United Nations publication, Sales No. E.98.II.D.6.

[5] The elements of the Washington consensus include fiscal discipline (as indicated by the overall budget position), redirecting fiscal expenditure to health, education and infrastructure, curtailing subsidies, broadening the tax base and lowering marginal tax rates, eliminating multiple exchange rates and making the unified exchange rate competitive, making property rights secure, deregulating the domestic economy, liberalizing foreign trade, privatizing State enterprises, eliminating barriers to foreign direct investment, and financial liberalization (see "What Washington means by policy reform", in *Latin American Adjustment: How Much Has Happened?*, John Williamson, ed. (Washington, D.C., Institute for International Economics, 1990), pp. 7-20). In its original formulation, financial liberalization did not extend to international financial flows.

[6] The sequence of policy programmes in Thailand, Indonesia and the Republic of Korea can be traced in "IMF's response to the Asian crisis", 30 July 1998, available on the Internet at

www.imf.org/External/np/facts/asia.htm

[7] The Managing Director of IMF, in his remarks to the special high-level meeting of the Economic and Social Council of the United Nations with the Bretton Woods institutions held on 18 April 1998, noted that IMF had been working towards full current-account liberalization for over 50 years and had not yet reached that goal for all countries and that presumably it would take a like period for capital account liberalization (see E/1998/SR.4).

[8] The letter from Charles Dallara, Managing Director, IIF, to Philip Maystadt, Chairman of the Interim Committee of IMF, dated 8 April 1998, says that the "private financial community supports the prudent and progressive liberalization of capital account transactions, but it is clear

now that liberalization should be approached with care and complemented by steps to strengthen domestic financial systems. The Fund has a central role in furthering capital account liberalization. However, the case has not been made that an amendment of the IMF Articles is necessary" (see www.iif.com/PublicPDF/icdc0498.pdf on the Internet).

[9] In this regard, at the end of June 1998, the Executive Board of IMF initiated an external evaluation of its surveillance role, which will complement the external evaluation, completed in March 1998, of economic policy programmes under the Enhanced Structural Adjustment Facility (the Fund's concessional lending arm) (for text and discussion of the latter, see www.imf.org/external/pubs/ft/distill/index.htm).

[10] The meeting, organized by the Department of Economic and Social Affairs of the United Nations Secretariat, in cooperation with the regional commissions of the United Nations, asked, "What have we learned one year into the financial crisis in the emerging market economies?" (The agenda of the meeting and its main papers may be found on the Internet at www.un.org/esa/analysis/expert.htm.)

[11] For a review of budgetary targets, see *World Economic and Social Survey, 1997* (United Nations publication, Sales No. E.97.II.C.1 and corrigenda), chap. V; see also Economic Commission for Latin America and the Caribbean, *The Fiscal Covenant: Strengths, Weaknesses, Challenges* (LC/G.1997(SES.27/3)), of 23 April 1998.

[12] Another option – followed, for example, by countries employing "currency board" systems – is to announce a permanent peg and commit to defending the peg no matter how great the disruption of the economy that is required. If confidence is maintained, the durability of the system need not be tested. Once confidence is lost, however, a deep economic contraction and high unemployment may have to be withstood before confidence in the peg is restored. The attraction of the peg, particularly in the currency board variant, is that it can be a potent tool for fighting high inflation, in which case it can be seen as an alternative to discredited central-bank currency management. Given the possibility of policy-induced economic contraction, however, it is a policy with some risk.

[13] A currency speculator should be thought of not as belonging among the limited number of "hedge fund" managers who operate internationally, but as being potentially any financial or non-financial enterprise or individual with access to credit who perceives the low-risk, high expected return of a bet against a central bank with limited foreign exchange reserves that is trying to defend an overvalued exchange rate.

[14] An importer having to make payment some weeks in the future could know precisely the local currency cost of the foreign currency obligation by making a forward foreign currency purchase, in which the price is set today for a transaction that is to take place at the agreed future time. "Futures" contracts are standardized securities that serve as a forward hedge. However, as they are securities, futures, like other derivatives, can be issued and traded in their own right and take on a life of their own which may become divorced from the underlying international trade and investment flows they were initially established to serve.

[15] The point here is not to prevent foreign direct investors from operating in a local financial sector, but to limit foreign financial inflows (for example, direct investment might be permitted in local brokerage houses, while foreign purchases on the local stock exchange might not be allowed).

[16] See Manuel Agosin and Ricardo Ffrench-Davis, "Managing capital flows in Chile", paper presented to the United Nations Expert Group Meeting: What have we learned one year into the financial crisis in emerging-market economies?, United Nations, New York, 21–23 July 1998 (available on the Internet at www.un.org/esa/analysis/expert.htm).

[17] Little national data on stocks (as opposed to flows) of financial assets and liabilities are collected even by countries with sophisticated statistical systems, although the conceptual framework for detailed balance-sheet data is already part of national income accounting (see Commission of the European Communities, IMF, Organisation for Economic Cooperation and Development, United Nations and World Bank, *System of National Accounts, 1993* (United Nations publication, Sales No. E.94.XVII.4)).

[18] See "Core principles for effective banking supervision", Basle Committee on Banking Supervision (available on the Web site of the Bank for International Settlements (www.bis.org/press/index.htm), release of 22 September 1997). The Basle Committee has also formed liaison and consultation groups with a number of countries (joined by IMF, the World Bank and the European Commission in informal capacities) in order to assist in implementation.

[19] The Basle Committee, in particular, adopted the approach in its 1996 amendment to the Basle Capital Accord. The Accord was the 1988 agreement that established common capital backing ratios for banks to protect against credit risk, which arises from the possibility of non-payment of principal or interest by borrowers. The 1996 amendment standardized protection against market risk (arising from possible changes in the prices of financial instruments in which a bank has an exposure) and in doing so allowed banks to use internal risk models to figure the required capital backing; it also put regulators in the position of assessing risk management models.

[20] Indeed, in July 1998, the Institute of International Finance (IIF) established several working groups of private sector financial executives to learn from the Asian crisis, including by assessing the performance of risk management models and processes during the crisis (IIF press release, 7 July 1998).

[21] These questions, *inter alia*, are being considered by the Joint Forum on Conglomerates, comprising the Basle Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors, which in February 1998 released a set of consultative papers for discussion (see www.bis.org/press/index.htm, release of 19 February 1998).

[22] For an example of the former, see the report of the Committee for Development Planning on its thirty-second session (*Official Records of the Economic and Social Council, 1998, Supplement No. 14* (E/1998/34)); for an

example of the latter, see the proposal of the Minister of Finance of Canada at the meeting of the Interim Committee, 15 April 1998 (in a press release of the Department of Finance of Canada, 15 April 1998).

[23] See "Strengthening the architecture of the global financial system", report of G-7 Finance Ministers to G-7 Heads of State or Government for their meeting in Birmingham, 15 May 1998, para. 17.

[24] Joint Ministerial Statement, Special ASEAN Finance Ministers Meeting, Kuala Lumpur, 1 December 1997, para. 12.

[25] See report of the Secretary-General on financing of development, including net transfer of resources between developing countries and developed countries (A/53/228).

[26] The debt agreements of the Republic of Korea are reviewed in the report of the Secretary-General on enhancing international cooperation towards a durable solution to the external debt problem of developing countries (A/53/373).

[27] See Group of Ten, *The Resolution of Sovereign Liquidity Crises*, a report to the Ministers and Governors prepared under the auspices of the Deputies, Basle, Bank for International Settlements, May 1996, para. 84.