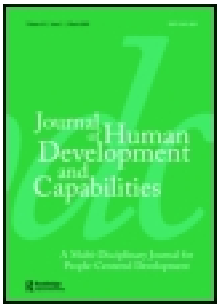

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International Financial Volatility

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Abstract The authors argue for reforms in the international financial system to deliver sufficient and sufficiently stable private and public flows, and to sustain more rapid growth and investment in developing countries. The paper begins with an analysis of the way in which international financial volatility impacts on developing countries, and how financial and economic crises often become social crises with devastating consequences for human security, giving illustrations from Indonesia and Argentina. The authors then critically analyse current plans for reform of the international financial system, and make recommendations to strengthen global regulation, provide liquidity, arranged for orderly debt workouts, democratize global governance, and protect the poor during periods of financial disturbance.

Key words: Finance, Economics, Poverty, Human Security, Governance, Debt

Introduction

The profound imperfections of the global financial system impact strongly on human security — defined as 'survival, daily life and dignity of human beings'. In fact, it can be argued that, at present, the global financial system is the Achilles' heel of the globalization process.

From a human security and a development perspective, the international financial system should deliver sufficient and sufficiently stable private and public flows to sustain more rapid growth and investment than would otherwise take place in different developing countries.

Unfortunately, the reality is different. Many developing countries attracted abundant private flows during the first 6 years of the 1990s. Although these flows initially helped fund somewhat higher growth, and reduction of poverty, they generated macro-economic disequilibria, such as over-valued exchange rates, growing current account deficits, and so on; these disequilibria made countries vulnerable to changes in perceptions of private lenders and investors. Initially, investors and lenders do not see deterioration in the current account accumulation of external liabilities as a problem, given their perception of high profitability and low risk. Suddenly, there is some change (which may be domestic or international, economic or

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political, important or small). The key point is that perceptions are sharply modified, leading to a sharp fall in confidence in the economy among internationally mobile investors (both foreign and domestic). This fall in confidence may be, in some cases, totally due to factors external to the country. Indeed, countries previously perceived as very successful are particularly prone to crises (Ffrench-Davis, 2001). Large inflows are reversed and become massive outflows. Exchange rates collapse, the banking system comes under pressure or breaks down. Economic activity falls sharply, as do employment and real wages.

Many people who previously had secure jobs and livelihoods suddenly lose them. Many others feel vulnerable, threatened by the risk of losing work and/or income; thus their human security is threatened (Sen, 2000). This happened in Mexico (1994–95), in the East Asian crisis (1997–98), when the most successful developing economies suffered a crisis that undermined or threatened millions of people's security, in Russia (1998), in Brazil (1999), in Argentina, Turkey and Uruguay more recently, and is now threatening to happen in Brazil again. Crises have become so frequent in the 1990s and in the twenty-first century that, about one-third of the time, major crises have been taking place. Furthermore, financial crises —which have tended in the past to be more restricted to national borders (except in the 1930s) — now spread via contagion in globalized financial markets.

Frequent and serious crises not only cause immediate increases in poverty, they also undermine future long-term growth, as volatility and uncertainty seriously discourage domestic investment and employment. Thus, crises, and the threat of crisis, can undermine future falls in poverty and increases in human security. The volatility and pro-cyclicality of flows also constrain the ability of national economic authorities to implement macro-economic policies that support growth and poverty reduction. To prevent currency crises, Central Banks often feel obliged to pursue very tight monetary policies, leading to high interest rates that can discourage investment and weaken banks and firms. To tackle crises, governments often resort to cutting government spending in order to reduce fiscal deficits or generate fiscal surpluses. This not only reduces growth, but asymmetrically tends to hurt the poorer and less secure members of society more. Indeed, crises tend to hit the poorer and more vulnerable hardest, particularly because the welfare losses for people near or below the poverty line are far greater.

Not only have net private flows to developing countries been volatile, they have fallen dramatically in recent years. Recent figures produced by the Institute of International Finance (2003) show that net private flows to emerging markets during 2002 stood at \$112.5 billion; the lowest total for a decade, and well below the annual average for the 1990s of \$185 billion. These sharp falls in the level of private flows reflect both cyclical and structural problems. This very serious situation is having a negative impact on growth rates for a large number of developing countries, particularly in Latin America where observers are expressing fears of a 'second lost decade'. From the perspective of human security and poverty reduction, major changes in the international financial system that will help encourage sufficient and sufficiently stable flows and avoid frequent crises are urgent and essential.

Financial volatility and human security

This section of the paper begins by looking at international financial volatility and the way in which it impacts on developing countries, and how financial and economic crises often become social crises with devastating consequences for human security. It then goes on to look in more detail at two recent crisis episodes — Indonesia in 1998, and the ongoing crisis in Argentina.

International financial volatility and the costs for developing countries[1]

Financial markets have traditionally been inherently short term and volatile. However, recent experience indicates both that these markets seem to have become more volatile and that this volatility has the potential to be transmitted in greater and more harmful ways on macro-economic trends in developing countries.

Indeed, although the conventional view is that developing country fundamentals determine the behaviour of international financial markets, there is increasing evidence that in many cases it is the endogenous behaviour of international financial markets that conditions or strongly influences fundamentals in developing countries (Fitzgerald, 2002). This makes regulation and other public interventions in international financial markets essential.

An important element of increasing volatility of bank lending is the use of modern risk management models (such as Value at Risk). As Persaud (2002) points out, the intrinsic problem with market-sensitive risk management systems is that they incorrectly assume banks act independently. In fact, the decisions of banks are interconnected. As many banks try to sell the same asset at the same time, and there are few or no buyers, prices fall and volatility increases. As prices collapse, for liquidity reasons, banks try to sell another asset, which may not have been previously correlated with the first. This not only increases volatility on the second asset, but also correlation. This will create repeated rounds of selling among agents adopting similar models, as generalized herding takes place. The adoption of banks' own risk management models for determining banks' levels of capital (as proposed in the new Basle Capital Accord) can seriously increase the banks' own tendency towards pro-cyclicality of lending, exacerbating both booms and crashes (see Griffith-Jones and Spratt, 2001).

An additional source of concern as regards pro-cyclicality of flows is that, although Value at Risk models were first developed by banks, similar models have been adopted to an important extent by fund managers and pension funds, leading to similar herding patterns and to pro-cyclicality of their investment. Furthermore, this means that herding affects not only one class of actors (banks), but spreads across actors.

The problem is not just one of pro-cyclicality of flows, but also one of the increased frequency of boom-bust cycles. As Williamson (2002) has argued, this is linked to the fact that financial markets are currently dominated by investment managers with a short-term philosophy, who are willing and able to move in and out of different markets in a relentless quest for short-term returns. This search for short-term returns is strongly influenced by the fact that fund managers are evaluated at very short-term intervals (Griffith-Jones, 1998). Not only is it doubtful that this behaviour maximizes long-term returns, but it is also clear that it does not maximize the usefulness of financial markets to developing countries that raise funds from them.

The problem of pro-cyclicality is further accentuated, especially in relation to bond flows to developing countries, due to the increased influence and impact of rating agencies on the terms and magnitude at which developing countries can tap world bond markets. As Reisen (2002) shows, sovereign ratings lag rather than lead markets, and have an important pro-cyclical effect — especially on the bond market. Improved ratings reinforce euphoric expectations and excessive capital inflows during booms, while during crises downgrading of ratings adds to panic among investors, causing capital outflows and higher spreads. The impact on flows is increased by the requirement of certain institutions (e.g. pension funds) to sell once ratings fall below a certain level. This is particularly marked in the fall from investment to non-investment grade ratings.

The large growth of derivatives in recent years can have positive effects on hedging or managing risks associated with capital flows for individual lenders and investors. During normal times, the unbundling of risk and increased liquidity offered by derivatives is positive. However, derivatives — even if used by foreign and domestic firms to hedge their investment — can contribute to downward pressure on emerging market currencies, and can even precipitate or seriously deepen the devaluation, as investors rush to hedge their currency exposure in anticipation of a possible currency crisis or to meet collateral requirements once the currency and asset prices fall.

Volatility and the costs for developing countries

Capital flows to developing countries tend to be much more volatile than capital flows within developed economies (see Griffith-Jones and Cailloux, 1999). As developing country economies are more fragile, and capital inflows are larger in relation to economic activity, external shocks related to international capital flows tend to have far larger impact than in developed countries.

The financial crisis in East Asia in the late 1990s provides a salient example of the excesses of international financial volatility and the impact that it can have on developing economies. Flows to the five East Asian countries hardest hit by the crisis (South Korea, Indonesia, Malaysia, Thailand and the Philippines) went from positive $93 billion in 1996 to a negative

$12 billion in 1997. This turnaround of $105 billion in a single year represented 11% of the combined pre-crisis Gross Domestic Product (GDP) of these countries.

Not only is the volatility of capital flows higher in developing countries than in developed economies, but the cost of volatility is also higher. The cost of currency and banking crises tend to be higher, and recovery periods long. Increasingly, banking and currency crises are inter-connected, as collapses of capital flows, sharp devaluations, and high interest rates lead to banking crises. This phenomenon, which is often preceded by financial liberalization, has been termed 'twin crises' (Kaminsky and Reinhart, 1998).

Honohan and Klingebiel (2000) sample 41 episodes of systemic banking crises. They show that governments, and so ultimately taxpayers, have largely met the costs of banking crises. These costs are larger on average in developing countries than in developed economies, an average of 14.3% of GDP compared with an average of 12.8% in developed countries. Some of the developing country banking crises in their study involved much larger costs; up to 55% of GDP was spent to resolve banking crises in Argentina and Chile (in the early 1980s) and in the worst hit of the Asian crisis countries in the late 1990s. All these were cases of 'twin' banking and currency crises. Honohan and Klingebiel (2000) show that developing countries as a group have suffered cumulative fiscal costs in excess of US$1 trillion to resolve banking crises over the past 25 years. The cost of resolving banking crises combines with other factors to severely constrain government resources for social spending during a crisis.

Financial crises in developing countries can soon become economic crises. During economy-wide crises, there are a number of channels through which the living standards of poor people and those living close to poverty can be affected.

- A reduced demand for labour, with falls in real wages, and increases in unemployment and less secure forms of employment.
- Non-labour incomes fall as economic activity slows, and the prices of goods and services produced by poor people may fall relative to other prices; the quantity demanded will also fall.
- With a currency devaluation, there are large increases in the price of imported goods such as food and medicine.
- Reduction in the availability of credit, with negative consequences for poor households and small and medium-sized enterprises.
- Fiscal austerity can result in a lower level of public transfers, with cuts in government spending and the provision of basic services, especially health and education.
- Reduction in human and physical capital — for example, through reduced food consumption, sale of assets, and removing children from school — can have both an immediate and a long-term negative impact on poverty and inequality.

Crises hurt both the poor and the non-poor, but they are more damaging to those who are already living in or close to poverty, even if they are not hurt

TABLE 1. Economic crises and incidence of poverty

	Before crisis	Year of crisis	After crisis
Mexico	36.0 (1994)	—	43.0 (1996)
Thailand	11.4 (1996)	12.9 (1998)	—
Indonesia	11.3 (1996)	18.9 (1998)	11.7 (1999)
Russia	21.9 (1996)	32.7 (1998)	—
Argentina	35.9 (2001)	53.0 (2002)	—

Source: World Bank (2001) and INDEC (2002).

disproportionately (World Bank, 2000). Poor people are less likely to have resources, such as savings, to help smooth shocks and, in many developing countries, social safety nets are not adequately developed to protect the poor.

During economic crises many people become poor temporarily, and social indicators can worsen or improve more slowly. Crises can also increase persistent poverty, due to irreversible deterioration in the human capital of poor people, and especially poor children. Crises, therefore, can have a long-term negative impact on the capacity of poor people to escape from poverty and to participate in recovery when it does begin.

Table 1 presents the increases in the incidence of poverty in a selection of recent crisis episodes: the Mexican peso crisis of 1994–95, the East Asian crisis of 1998, the Russian financial crisis in 1998, and the current crisis in Argentina. Most of the countries affected by the East Asian crisis saw rising levels of poverty; in Indonesia, poverty is estimated to have increased by nearly 50%. The impact of crises on inequality is less clear. Inequality may rise, fall, or remain the same during crises. However, when crises are accompanied by increases in inequality, economic contraction can more than reverse previous gains in poverty reduction (World Bank, 2001).

World Bank (2001) research has also shown that most social indicators either deteriorate or improve more slowly during economic crises. Health indicators that are sensitive to reduced food consumption or decreases in income tend to worsen. As a result of the Mexican crisis in 1995, for example, infant and pre-school mortality caused by nutritional deficiency rose. Education indicators, such as school attendance and literacy rates, also suffer during economic crises. In the Philippines, increases in secondary school enrolments increased more slowly following the Asian crisis, as did primary enrolment in Mexico following the 1994–95 crisis. It is also important to bear in mind that these figures are national averages and therefore probably reflect a deterioration in these indicators among the more vulnerable sections of society.

Indonesia. The devaluation of the Thai currency in 1997 triggered a process of contagion that caused currency and financial crises for many economies in East Asia. Before the crisis, these same countries had managed an impressive record of high and sustained growth over three decades, and made important advances in poverty reduction.

The Indonesian crisis was the most extreme case of this reversal of fortune.[2] Indonesia, which had registered impressive economic growth rates and improvements in human development indicators since the 1970s, became the worst hit of the Asian crisis countries. Severe economic contraction, sharp currency depreciation, bank insolvency and high inflation all contributed to a worsening of living standards and a doubling of the incidence of poverty. Human security in Indonesia was severely undermined during 1998, not only because the fall-out from the financial and economic crisis fuelled existing social and political tensions, but also because it was accompanied by a natural disaster in the form of El Nino.

The financial crisis in Indonesia was characterized by a large-scale reversal of private capital flows, the largest currency depreciation in the region and the collapse of the banking sector. The impact on the Indonesian economy was devastating. A number of factors related to the crisis — among them the reduction in the availability of domestic and external credit, reduced investment, and the fall in domestic demand — combined in causing a sharp economic contraction. Whereas GDP growth in Indonesia had been strong for many years before the crisis, it fell from a positive 4.7% in 1997 to a negative 13.2% in 1998, representing a reduction of nearly 18% in just one year.

The social impacts of the economic crisis in Indonesia were deep and widespread. Income per capita experienced a dramatic decline in Indonesia, falling 14% between 1997 and 1998. This meant that many Indonesians had to reduce consumption and deplete savings and assets. Reduced demand for labour caused a decline in real wages and shifts from formal to informal sector employment, as well as some unemployment. At the same time, public expenditure was cut, with some of the biggest cut-backs in areas that impact most on the lives of people living in or close to poverty, such as education, social security and housing.

Poverty in Indonesia increased dramatically as a result of the crisis. While different methodologies for measuring poverty incidence will have different results, all the figures for Indonesia show that the crisis caused an increase in poverty in both absolute and percentage terms. As presented in Table 1, according to World Bank figures, the incidence of poverty in Indonesia nearly doubled in Indonesia between 1996 and 1998. Official Indonesian statistics show that the number of people living in poverty increased by 27 million between 1996 and 1998, with 16.6 million of those living in rural areas (Indonesian Central Bureau of Statistics, 2000).

There was also a deterioration in a number of social indicators in Indonesia as a consequence of the crisis. As private consumption fell, health indicators sensitive to such shifts worsened. The number of women whose body mass index was below the level at which health risks increase rose by one-quarter in 1998, and the average weight of children under the age of 3 declined. Education indicators also deteriorated in Indonesia as a result of the crisis. The proportion of poor children not enrolled in school increased from 4.9% to 10.7% in 1998 in the 7–12 age group, and from 42.5% to 58.4% for the 13–19 age group (World Bank, 2001). School dropout rates for poor children in both age groups also increased as a result of the crisis. These health and education indicators for Indonesia show that crises can have serious negative impacts on the human capital of poor people. While Table 1 shows that the incidence of poverty in Indonesia decreased significantly in 1999, the impact on the lives of many poor people, especially poor children, will have been much more long term.

Argentina. Since the Asian crisis, the countries of Latin America have experienced slow growth. Although there have been a wide variety of experiences among the different countries, the slowdown has been widespread and per-capita GDP has fallen in some countries. By the end of 2002, per-capita output for the region will have fallen to nearly 2% below 1997 levels — making this year what the Economic Commission for Latin America and the Caribbean (2002) has referred to as the fifth 'lost year' in a row.

An important factor behind this slow growth has been the less favourable terms and conditions of external financing since the Asian crisis. In 2002, Latin America as a whole is expected to register a net outward transfer of resources for the fourth year running. External finance to the region has been scarce, expensive and volatile since 1998, but conditions have worsened recently as investors and lenders have become even more risk adverse — partly as a consequence of the crisis in Argentina.

In Argentina, the recession that began in 1999 has worsened considerably as a result of the financial and economic crisis. In 2001, GDP fell by 4.5% and in 2002; a further fall of 13.5% is expected. Investment has fallen to nearly one-half its former level. 2002 has seen a 70% fall in the peso, and inflation is expected to hit 60% by the end of the year. The limits imposed on bank withdrawals caused steep falls in consumer spending and credit availability, and seriously damaged consumer confidence.

Economic contraction has forced thousands of companies out of business. As a result, demand for labour has dwindled, leading to heavy job losses and a steep fall in real wages. Unemployment now stands at around 22%, bringing the number of workers either unemployed or in part-time jobs to some 5.6 million. Real monthly wages have declined by 18% over the course of a year (Centre for Economic and Policy Research, 2002).

Poverty in Argentina has risen sharply as a result of the crisis. By May 2002, the number of poor people in Argentina had risen by 6.15 million to a staggering 19 million — or 53% of the total population (INDEC, 2002). Of the 19 million people in poverty, nine million are living in extreme poverty — representing an increase of 4.5 million in one year. Children have been particularly hard hit by the crisis, with reports of malnutrition and hunger in various provinces and in the suburbs of Buenos Aries (Centre for Economic and Policy Research, 2002). Poverty levels in Argentina have never before risen so much in such a short space of time.

The main reasons for the sharp increase in poverty in Argentina are increases in unemployment and in less secure employment, the fall in wages and the steep increases in the price of basic goods.

Threats to human security resulting from the crisis go beyond the negative economic impacts and the devastating increases in poverty. The economy-wide crisis has resulted in a high degree of social unrest and political instability. There have been numerous changes in the political leadership in Argentina, and even fears at one point that the fall-out from the economic crisis might result in a return to dictatorship. Human security has been further undermined by the spread of violent crime in Argentina since the outbreak of the crisis.

Reforms to the international financial system

The financial and economic crises of the past decade highlighted the inadequacies of global governance in managing economic and financial integration, and generated a broad consensus that fundamental reforms are required to the international financial system. Reforms at the national, regional and international levels will all be important in order for global economic and financial integration to contribute to increased human security. As reforms at the national level have attracted more attention elsewhere, this paper will focus on some of the reforms that are necessary at the international level.

Strengthening global regulation

One of the key functions to be met so that a global financial system works effectively, to sustain both stability and growth, is that of appropriate transparency and regulation of international loan and capital markets (Ocampo, 2002). These markets have become increasingly integrated between countries, as well as increasingly integrated among each other, as big financial conglomerates combine activities in banking, securities, insurance and other financial fields.

For regulation to be efficient, it is essential that the domain of the regulator is the same as the domain of the market that is regulated. Ideally, this would imply the need to create a global regulatory authority, as Kaufmann (1998) and Eatwell and Taylor (2000) have suggested. However, this seems at present unlikely, both because of the complexity of the task and because of the unwillingness of national governments and regulators to give up sufficient sovereignty on this issue.

A second best to creating a global regulatory authority is to significantly improve exchange of information and co-ordination among regulators, both across countries and across financial sectors. In the past two decades, there had been initial steps in this field, mainly via the three Basle Committees. As a result of the East Asian Crisis, a potentially very important institutional innovation occurred: the creation of the Financial Stability Forum to identify vulnerabilities and sources of systemic risk, to fill gaps in regulations and to develop consistent financial regulations across all types of financial institutions. However, although the Financial Stability Forum (FSF) working parties have produced some very high-quality reports with important recommendations on, for example, highly leveraged institutions, these are likely to have a limited influence on decisions taken by national regulators, particularly in source countries.

The Basle Capital Accord. The potentially most important regulatory development since the East Asian crisis is the proposed modification of the 1988 Basle Capital Accord, which could have profound negative impacts on bank lending both to and within developing countries. Since the Asian crisis, bank lending to developing countries became negative (Bank for International Settlements, 2001). It is in this context that the implications of the proposed new Basle Capital Accord need to be assessed, given the great concern that it could further discourage lending.

The key proposed change in the Basle Accord relates to the measurement of credit risk, and will base the calculation of capital on the banks' own models of risk. The January 2001 consultation draft of the proposed reform of Basle raised serious concerns that it could have a large net negative effect on developing countries. Despite subsequent modifications to the proposal that have dealt with some of the issues raised, several aspects are still problematic for developing countries.

The first problematic aspect is that the proposed changes to the Basle Accord would most probably further reduce international bank lending and could significantly increase costs of such lending to most developing countries, particularly those (the large majority) that do not have investment grades.[3] Low-income countries would be especially badly hit.

Second, the proposed changes would exacerbate pro-cyclical tendencies within the banking systems as capital will be determined by banks' own models that are inherently pro-cyclical. For developing countries, increased pro-cyclicality of bank lending is particularly damaging, given that this contributes to increase further the likelihood of crisis, as well as their development and financial cost. The Basle Committee seems to have accepted this criticism, and is reportedly planning to include measures to combat pro-cyclicality in the next consultative proposal.

To counteract the negative consequences of Basle on developing countries, regulatory action needs to be taken to compensate not just for the natural tendency of banks towards pro-cyclicality, but also for the accentuation of this trend by the introduction of Basle II. One useful mechanism would be dynamic or forward-looking provisioning, which would be estimated when loans are disbursed on the basis of expected losses. Such an approach could build on the Spanish and Portuguese experience of 'statistical provisioning' for 'latent' risks that explicitly recognizes that risks are incurred when credits are approved and disbursed, not when they come due; this mitigates cyclical behaviour of banks.

The provision of liquidity

During the 1990s, capital account liberalization and the large scale of private capital flows greatly increased the need for official liquidity to deal with sudden and large reversals of flows. As a result of the East Asian and other large crises, International Monetary Fund (IMF) resources were significantly enhanced. This facilitated the provision of fairly large financial packages to assist in the management and containment of crises. However, there are still a number of problems around the provision of emergency financing and crisis management. This section outlines two areas of possible policy reform — IMF facilities and Special Drawing Rights (SDRs) — that could contribute to better crisis management.

IMF financing facilities. Two new facilities were designed as a result of the East Asian crises. The first of these was the Supplementary Reserve Facility. This facilitated the provision of fairly large, more expensive, relatively short-term loans to countries hit by crises. The Supplementary Reserve Facility was useful in providing large loans to countries like South Korea and Brazil, once they were hit by major crises.

The second facility created after the East Asian crisis was a preventive one, the Contingent Credit Line (CCL). As the IMF defined it, the CCL was created as "a precautionary line of defence readily available against future balance of payments problems that might arise from international financial contagion". To qualify, the increased pressure on a country's capital account and international reserves must thus result from a sudden loss of confidence among investors triggered by external factors.

The CCL was thus a potentially very important and positive step because it could significantly reduce the chances of a country entering into a crisis, by providing contingency lending agreed in advance. However, despite a modification in the terms and conditions of the CCL designed to make it more attractive to borrowers, to date no country has applied to use it. The key problem is that of the perceived stigma attached. Developing countries with 'good' policies fear that applying for a CCL could be counter-productive and reduce — rather than strengthen, as is the intention — confidence of the markets in that country.

To realize its potential, the CCL needs to be modified in such a way as to make it more attractive and to diminish any potential stigma. One option would be that all countries that have been favourably evaluated by the IMF in their annual Article IV consultations could automatically qualify for the CCL. As a large number of countries, including the developed ones, would qualify and the CCL could be seen as a sign of strength, rather than as a sign of possible future weakness, the stigma on its use would be eliminated.

The role of SDRs. Over the past two decades, the increasing need for IMF funds to finance its services has been satisfied with increases in quotas and arrangements to borrow. As these funds have been clearly insufficient, major rescue packages have involved additional bilateral contributions from major industrialized countries. This has two major weaknesses. First, it makes such rescue operations dependent on decisions by a specific set of countries, a fact that reduces its multilateral character and introduces discretionary elements in an area that should certainly be rules based. Second, it reduces the stabilizing effect of rescue packages if the market deems that the intervening authorities are unable or unwilling to supply funds in the quantities required (Griffith-Jones and Ocampo, 2002).

One solution would be to allow additional issues of SDRs during episodes of world financial stress. SDRs were created in 1969 as a global reserve currency. However, since their creation, there have only been two series of SDR allocations.

Proposals to renew SDRs allocations have been increasing in recent years. They follow two different models. The first is the temporary issue of SDRs during episodes of world financial stress, which could be destroyed once financial conditions normalize (see Council on Foreign Relations Task Force, 1999; United Nations Executive Committee on Economic and Social Affairs, 1999; Camdessus, 2000). This procedure would develop an anti-cyclical element in world liquidity falls management whereby, in private, lending could be temporarily compensated in part by official liquidity, but would avoid creating additional long-term liquidity at the world level.

The second variant involves SDRs allocations as related to the increasing demand for international reserve assets. Allocations would thus be permanent. This could help developing countries that have felt the need to build up large-scale international reserves to meet the demands created by increasing international financial volatility. Proposals for permanent SDR allocations are also put forward as a means to finance other international objectives, particularly the provision of global public goods and international development co-operation. This is, indeed, the nature of the proposals made to the United Nations Conference on Financing for Development by the Zedillo Panel of Experts (Zedillo *et al.*, 2001).

Orderly debt workouts

International rules on debt standstills and orderly workout procedures are essential mechanisms to avoid the co-ordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments between lenders and borrowers, and to avoid 'moral hazard' issues associated with emergency financing (Griffith-Jones and Ocampo, 2002). Consensus on the need for such mechanisms has increased significantly over the past 2 years. Recent proposals by the IMF (Krueger, 2001, 2002) have fuelled the international debate on this issue. There has, however, been opposition from developing countries, who consider that this mechanism would increase the costs or reduce access to private international capital markets. There has also been opposition from the private sector in industrialized countries to the concept of non-voluntary arrangements. While there has been increasing debate on this issue, there have as yet been no concrete steps taken to establish such a mechanism.

There has been widespread support for the introduction of collective action clauses in debt contracts to facilitate eventual re-negotiations of bonds. This is a valuable mechanism that is easy to introduce. However, there have been some concerns over possible increased costs for countries that adopt them, although empirical evidence on balance shows the contrary. However, such concerns could be overcome and the process facilitated if such clauses were universal. Thus, the G-7 countries should lead the process, as they suggested in October 1998, shortly following the Asian crisis (Group of Seven, 1998). Several industrialized countries (such as the UK and Canada) have taken such action, but important countries (especially the US) unfortunately have not.

There is broad agreement that declaration of a standstill by the debtor country should be voluntary, but there should be some international mechanism that gives it legitimacy and avoids disruptive legal processes. The IMF seems to be best placed to play this role, particularly if provisions of Article VI of the Articles of Agreement are interpreted as providing the basis for such mechanism to be put in place.

It is also agreed that negotiations should be voluntary, and should include in an integral manner public and private sector debts. It would be useful for negotiations to be facilitated by an international mediator or, eventually, arbitrator. Doubts have been raised about the suitability of the IMF for this role, due to its status as a lender. UNCTAD has proposed that a different institution, probably within the United Nations system, should play that role. An alternative would be for the IMF to have the power to convene independent international panels to play such roles, on the principle that it would accept their recommendations.

Some developed countries have argued that debt standstills and orderly workout procedures should be adopted as an alternative to large rescue packages. There is usually a case for this view when countries face solvency problems, but it is incorrect when liquidity issues are involved. Indeed, due to the multiple equilibria considerations that characterize liquidity crises, emergency financing is essential for supporting 'good equilibria' results. The most clear case is that in which liquidity constraints — by reducing investor confidence and forcing countries to pay excessively high interest rates — effectively lead to a solvency crisis. This situation has become increasingly common in recent years.

The basic complementary role that adequate regulation, lending of last resort and debt workouts play in preventing and managing crises has been accepted for decades in domestic policies. It is hard to understand why they still tend to be seen as substitutes in international financing. A system in which standstills replaced emergency financing would probably increase market instability and/or increase spreads or severely ration financing to developing countries. This would be particularly dangerous in an environment in which net private capital flows to developing countries have collapsed.

Democratic global governance

Under current global governance arrangements, the participation of developing countries in the key fora where international financial reform is discussed is severely limited. There would be a number of important benefits from greater developing country participation in global financial governance. First, developing countries would benefit by having a stronger voice. Second, international institutions would benefit from enhanced legitimacy; after all, developing countries represent 85% of the world's population and a significant proportion of global GDP, especially when measured using Purchasing Power Parity methodologies. Last, but certainly not least, greater participation by developing countries in global financial governance would ensure greater commitment by these countries to open markets, an aim shared by all developed countries. This section outlines the case for increased participation in three key institutions: the FSF, the Basle Committee on Banking Supervision, and the IMF.

The FSF is potentially a very valuable institution. Unfortunately, the composition of the FSF is very problematic as developing countries are totally excluded (except major financial centres — Hong Kong and Singapore). Developing countries do have some *ad hoc* participation (by invitation only) in the Working Parties and, recently, the FSF has organized outreach regional activities, such as meetings in Asia and Latin America. However, full participation of developing countries in the FSF has not been granted. This is despite the stated intentions of the G-7 at the time the FSF was created: "while initially the FSF would be limited to G-7 countries, it is envisaged that other national authorities, including from emerging economies, will join the process at some stage".

Similarly, there is no representation of developing countries on the Basle Committee for Banking Supervision. Although efforts to increase *ad hoc* consultation with developing and transition economies, which both these bodies have increasingly carried out in recent years, is clearly welcome, it is no substitute for appropriate and formal representation. Developing countries could be included in these fora on a rotational basis, without significantly increasing the size of these groups and therefore not jeopardizing their effective working methods. For example, there could be one or even two representatives per developing country region (Latin America, Asia and Africa), who would be nominated for 2 years and then rotated.

In the case of the IMF, the out-dated quota and voting system lies at the heart of the institution's governance problem. Voting power at the Fund consists of two components. As a symbolic recognition of the principle of the legal equality of states, and to help ensure participation of smaller and poorer countries, each member country has 250 basic votes. Each member also has one additional vote for every 100 000 SDRs of its quota. Because the number of basic votes has not increased as quotas grew, the ratio of basic votes fell from around 11% of the voting power of the 45 founding members in 1944 to less than 3% in the 1990s, even though the number of members tripled.

Restoring the share of basic votes to the original 11% would require a more than fivefold increase in the basic vote of every country. Restoring the proportion of basic votes per member to its 1945 level would raise the total basic votes to 46% of the total voting power. An intermediate solution to partially restore the role of basic votes would be to assign to basic votes say 25% of total voting rights. Furthermore, the use of Purchasing Power Parity-based GDP estimates in the quota formulas would also enhance the role of developing countries in the IMF Board.[4]

An additional measure that would improve Fund governance would be to reform the constituency representation on the Executive Board. For example, the number of Chairs allocated to the sub-Saharan African countries, which are only two in total, could be increased to three.

Protecting the poor during periods of financial disturbance

As outlined in the second section of this paper, economic and financial crises in developing countries represent both immediate and long-term threats to human security. This section of the paper has outlined a number of reforms to the international financial system that would help to reduce the likelihood and severity or crises; it is regrettably unclear when or whether they will be adopted. Even if they are adopted at some point in the future, unfortunately financial and economic crises will continue to hit developing countries from time to time. It is therefore very important that more attention be paid to limiting the negative impact on living standards, and protecting the poor during periods of financial disturbance.

The crisis in East Asia highlighted the importance of adequate social protection mechanisms to protect the poor, and also generated a broad consensus that changes were necessary in the design of IMF policies during crises in developing countries. One important lesson from East Asia and other crises has been that, in order to limit the negative impact on living standards, it is essential that the social implications of programmes be mainstreamed into the design of macro-economic policy. It is particularly important that the IMF, in its country programmes, allows governments the fiscal policy space to pursue expansionary polices to counteract economic contraction during crises. This, in turn, would provide the fiscal space to continue with existing, and implement new, social protection measures.

Recent crisis episodes have also illustrated the need for strong social safety nets to manage the social repercussions of financial disturbances in developing countries. Social safety nets are made up of policies and programmes that provide emergency income support and access to basic social services to the poor during financial and economic crises. They are important in mitigating both the immediate and the long-term negative impact of crises; preventing more people from slipping into poverty, and helping individuals and households cope with the consequences of crises without undermining human capital. Social safety nets can include mechanisms such as unemployment insurance, income support, public works programmes, price subsidies, nutrition programmes, social service fee waivers and micro-finance programmes.

Analyses of social safety nets undertaken since the Asian crisis have drawn a number of conclusions. Key among these are the following.

- They should be part of permanent social protection schemes, so they can respond quickly to the needs of vulnerable people during crises.

- A combination of various programmes, with different target groups, is most effective.
- They should be country owned and designed, and principally financed domestically in normal times.

It is difficult for governments to fund sufficiently large social safety nets in times of crisis, as government revenues are falling as the needs of vulnerable people are increasing. For this reason, the international community should also be willing to provide assistance to developing countries with financing social safety nets during economic shocks. Appropriate mechanisms should be designed, and resources allocated, for this purpose.

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Notes

1 This section draws on papers prepared for the WIDER project 'Capital Flows to Developing Countries since the Asian Crisis: How to Manage their Volatility', co-directed by Ricardo Ffrench-Davis and Stephany Griffith-Jones. The papers are available on the WIDER website (http://wider.unu.edu/research/research.htm, see under Research 2000–2001). They will also be available in a forthcoming book.
2 The section on Indonesia draws on Pieraccini (2001).
3 For different estimates of potential cost increases, see Reisen (2001) and Powell (2001).
4 We are grateful to Ariel Buira for these points. See also Buira (1999).

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