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Managing Financial Instability in Developing Countries: Why Prudence is Not Enough

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Introduction

The evolution of real economic activity has come to be increasingly dominated by financial cycles in industrial and developing countries alike. With rapid capital account liberalization, conditions in global financial markets have gained added importance as an independent source of instability in developing countries. Driven primarily by factors beyond the control of these countries, these flows are susceptible to large and sudden shifts, capable of hitting even those with monetary and fiscal discipline and exceptional track record in industrial development. These flows often behave procyclically, becoming more easily available at times of expansion in income and leading to excessive spending and over-indebtedness, but drying up during downturns when they are most needed, aggravating economic contraction.

Various policy instruments are available at the national level for mitigating these procyclical effects. However, the scope and effectiveness of these instruments are limited and they involve significant costs and/or other policy dilemmas, particularly in countries with weak fundamentals. Moreover, there is often very little room for countercyclical policies, and countries often need to rely on multilateral institutions for support. The way this support is provided plays a key role in the management of financial instability and its impact on real economic activity in developing countries.

There has been so far little prospect for reform to secure greater stability of international capital flows through regulations at source. After the Asian financial crisis and its more widespread contagion, a consensus seemed to emerge on

restricting IMF bailout operations, reorienting its lending and policies to the support of trade, income, and jobs, and prudent regulation of capital flows and the involvement of the private sector in the resolution of liquidity crises. However, with the revival of private capital flows to developing countries, the shrinking of risk spreads, and a strong trade and growth performance, this agenda was put on the backburner, exposing countries unable or unwilling to take self-insurance to a sharp reversal of these exceptionally favorable global cyclical conditions. The financial crisis that began in 2008 and its aftermath put the issue of financial reform back on the table. Governments adopted unprecedented measures to save financial institutions and stimulate economic recovery. However, with signs of recovery there are growing worries that the reforms needed to bring about stability and to prevent a repeat of boom–bust conditions will once again be delayed.

With this history of stalled reform in mind, this chapter addresses policy options in the management of financial cycles and economic instability at the national and international level, focusing on systemically important areas of intervention. Its main policy conclusion is as follows: developing countries need to manage surges in capital inflows using monetary policy and financial control with a view to preventing unsustainable exchange rates and current account positions and exposure of private balance sheets to currency turmoil. In this task, they should be encouraged and helped by the IMF. The Fund should also provide adequate liquidity in support of countercyclical policies when developing countries receive adverse external shocks, including attacks on their currencies and rapid exit of capital. This assistance should aim at maintaining imports, income, and employment rather than repayment to private creditors and investors and capital account convertibility. The latter issues should be dealt with mainly through orderly debt workouts, including internationally sanctioned temporary debt standstills and exchange controls.

The discussion of this chapter is organized as follows. “Financial instability and the real economy” discusses financial instability and its impact on real economic activity. “Financial cycles and countercyclical policy: issues at stake” gives a brief description of the policy issues involved in managing financial cycles. “Countercyclical monetary policy” and “Prudential regulations, capital controls, and risk management” examine the scope for and effects of monetary policy and financial regulations and control, respectively, in the management of capital surges. “Reserve accumulation as self-insurance: burden or blessing?” examines the recent tendency among developing countries to accumulate international reserves as an insurance against sudden stops and reversals in capital flows. “Multilateral lending and countercyclical policy” examines the

multilateral approach to capital flows and countercyclical policy. The final section concludes.

Financial instability and the real economy

Procyclicality of finance

With growing deepening of financial markets and rapid growth of financial wealth, business cycles in both developed and developing countries are increasingly dominated by developments in the financial sector. It is true that there is not always a one-to-one correspondence between real and financial cycles, and recessions do not always go in tandem with financial crises. Nevertheless, the growing tendency of the financial system, including international capital flows, to respond procyclically to impulses emanating from the real economy reinforces expansionary and contractionary forces, thereby amplifying swings in investment, output, and employment. The financial system is also capable of generating autonomous influences that can result in gyrations in real economic activity. This is particularly the case in developing countries where boom–bust cycles in capital flows driven by external factors can exert a disproportionately large impact on economic performance, producing unsustainable expansions followed by financial crises and recessions.

Capital account liberalization has added a new and increasingly dominant dimension to financial cycles in developing countries, creating mutually reinforcing interactions among credit, capital, and currency markets. On the one hand, international capital flows tend to respond procyclically to domestic cycles. Economic expansion and booms in stock and property markets attract foreign investment and lending which can, in turn, appreciate the currency and hence make such inflows even more attractive. During the downturn, falling domestic asset prices can trigger capital outflows and currency depreciations which can, in turn, aggravate credit crunch and debt deflation.² More importantly, international capital flows can trigger domestic financial and business cycles. Surges in capital inflows due to favorable global financial conditions and the consequent currency appreciations could generate booms in domestic assets and credit markets, encouraging borrowing and spending. When such inflows stop suddenly or are reversed, it would be almost impossible to prevent financial meltdown unless there are adequate foreign exchange reserves or international lender of last resort facilities.

Destabilizing feedbacks between domestic financial markets and capital flows are much stronger in developing than industrial countries. Currency instability in industrial countries rarely spills over to domestic capital markets and the banking sector, while in most emerging markets major payments and currency crises are seldom contained without having a significant impact on domestic financial conditions and economic activity.³ Similarly, major banking and/or asset-market crises in developing countries often have adverse effects on international capital flows and currency markets, but this is not always the case in industrial countries.⁴

The greater susceptibility of domestic financial conditions and economic activity in developing countries to instability in international capital flows and exchange rates is often due to extensive dollarization of balance sheets and widespread currency mismatches. In a large majority of developing countries external liabilities in foreign currencies exceed by a large margin external assets, with the result that exchange rate changes can produce important shifts in net worth positions and procyclical wealth effects. This is a main reason why about 85 percent of all defaults in developing countries during 1970–1999 were linked with currency crises (IMF 2002; Reinhart 2002). In countries which hold large amounts of foreign currency reserves, these reserves are often concentrated in central banks or treasury funds while private balance sheets manifest vulnerability to currency declines. Even export sectors can be highly vulnerable to exchange rate swings when there is a maturity mismatch between their foreign-exchange-earning illiquid real assets and short-term foreign currency liabilities. Currency swings exert procyclical effects on economic activity; appreciations during boom lead to increases in net worth in balance sheets, supporting expansion in aggregate demand while depreciations at times of sudden stops and reversals add to contractionary impulses.

There can be little doubt that country-specific (pull) and global (push) factors can play important roles both in determining the direction, size, and nature of capital flows and on their impact. Strong and sustained growth, discovery of rich natural resources, rapid liberalization, large-scale privatization programs, and highly profitable corporate takeover opportunities can attract large amounts of foreign capital even when global financial conditions regarding risk appetite, liquidity, and interest rates are not very favorable. Nevertheless, as also noted by the World Bank (2003: 26), the “dynamics of net capital inflows and the changes of official reserves over the cycle do indeed indicate that the push factor is more important for middle-income countries, while the pull factor dominates in high-income countries.” In fact, the most damaging episodes of boom–bust

cycles in capital flows to developing countries in the postwar period are the ones driven by special and temporary global push factors beyond the control of the recipient countries, including monetary and financial policies in major industrial countries.

During the postwar period, there have been three phases of global cycles in capital flows to developing countries. The first was triggered by oil export earnings following the formation of OPEC in the 1970s. The second comprised of cycles of the 1990s generated by low liquidity expansion in the United States and Japan and debt overhang removal through the Brady Plan. The current, third spate of cycles began with the boom in 2002. Excess liquidity created by historically low interest rates in the United States and Japan and large oil surpluses, channeled to developing countries' asset markets directly, without the intermediation of international banks, were again the major drivers. However, a reversal began with the onset of the financial crisis of 2008. The global economy is yet to recover fully from the aftermath of this crisis.

Financial cycles and investment and jobs

Procyclical behavior of finance has far-reaching implications for the real economy. Sharp swings in asset prices, exchange rates, and aggregate demand cause fundamental uncertainty regarding the return on capital, shorten planning horizons, and promote defensive and speculative strategies in investment which can, in turn, exert significant adverse influence on the pace and pattern of capital accumulation, economic growth, and employment.⁵ Episodes of exceptionally rapid economic expansion driven by financial bubbles can no doubt bring greater prosperity, but they are also susceptible to producing deeper recessions or longer periods of stagnation, resulting in considerable waste of resources, including both capital and labor.

Investment has always been the most unstable component of effective demand, and more so in developing than in industrial countries.⁶ Instability of investment is greater in low-income countries where investment depends more heavily on imported capital goods, and is closely linked to commodity price movements. Procyclical response of international financial markets to export shortfalls often aggravates the impact of commodity shocks. Official aid flows also appear to be procyclical for this group of countries (Akyüz 2007a, 2007b, 2008, 2009). Consequently, the burden of adjustment to external shocks almost invariably falls on capital spending.

Evidence also suggests that instability of investment increased relative to that of GDP in the 1990s both in developing and in industrial countries.

Investment cycles are now much more pronounced than income cycles, with investment rising faster than income during expansions and falling faster during contractions. Increased instability is more pronounced in middle-income countries. This is closely connected with growing influence of international private capital flows. Although they are procyclical in both industrial and developing countries, in the former they tend to lag the domestic investment cycles while in developing countries they often, though not always, lead them (World Bank 2003: 26).

Tracking the behavior of investment and employment over the entire expansion–recession–recovery cycle dominated by financial developments reveals some similarities between developed and developing countries. In particular, losses of investment and employment incurred at times of recessions are not fully recovered when the economy bounces back from its trough, giving rise to the phenomenon of jobless recovery.⁷

Not only do boom–bust cycles distort the composition of investment, but also they tend to lower its average level over the entire cycle. In the four countries hit by the 1997s crisis in East Asia, the boom supported by strong capital inflows in the mid-1990s raised the average investment ratio by some 7 percent points of GDP. However, during the crisis, the average decline was more than 16 percent points. Investment stagnated in the subsequent recovery with the result that there was a sharp decline in the investment ratio over the entire cycle (UNCTAD TDR 2000).

In the labor market, booms generated by capital inflows often raise real wages, but the behavior of employment depends on several factors.⁸ Employment in traded-goods sectors tends to fall if the currency appreciates significantly. Investment and productivity growth are sluggish, and these may be offset only partly by expansion in services. Evidence shows that in almost all emerging markets, real wages rose during the boom phase. In Latin America, where productivity lagged behind wages, there was little change in unemployment, but in East Asia overall unemployment fell. In all these countries real wages fell and unemployment rose sharply during recessions, and in many of them unemployment rates exceeded the levels witnessed before the boom. Again, in all these cases the subsequent recoveries were jobless; the unemployment rates remained above the rates attained during expansion by between 4 and 6 percentage points even after income losses had been fully recovered. Indeed, evidence suggests that under conditions of increased instability and uncertainty, even longer periods of growth may fail to generate decent jobs.

Financial cycles and countercyclical policy: Issues at stake

A main challenge facing policy makers almost everywhere is how to manage financial cycles without sacrificing growth and employment. For most emerging markets, this is more about the management of international capital flows in view of their autonomous and strong influence on domestic financial conditions and real economic activity. It perhaps presents a greater challenge than attaining price stability which was once thought to be both necessary and sufficient for financial and economic stability. In most countries, both in the north and the south, financial boom–bust cycles, asset price and exchange rate gyrations, and credit surges and crunches have all occurred under conditions of low and stable inflation.⁹ In some developing countries, where price instability is traditionally regarded as structural and chronic, single digit and stable inflation rates have been attained at the expense of increased financial fragility and instability through exchange-rate-based stabilization programs, relying on short-term, unstable capital inflows (UNCTAD TDR 2003).

Industrial countries are often able to respond to financial turmoil and recessions by expanding liquidity and lowering policy interest rates, and occasionally through fiscal expansion. However, such options are not open to developing countries facing economic contraction resulting from a sudden stop and rapid exit of capital, because they cannot stabilize the debt contracted in foreign currencies and undo the balance of payments constraint. In a credit crunch involving foreign lenders and investors, central banks cannot act as lenders of last resort to stabilize the exchange rate and avoid hikes in the debt burden. Nor is there an international lender of last resort to undertake this task. Consequently, even when the problem is, in essence, one of lack of international liquidity, the collapse of the currency and hikes in interest rates could lead to insolvency of otherwise sound debtors.

Even in industrial countries where balance sheets are largely insulated from the impact of large currency swings, monetary easing designed to weather difficulties in the domestic financial system can run against external hurdles. It could weaken the currency and increase inflationary pressures, particularly when there is a large current account deficit that needs to be financed by capital inflows. The problem is certainly more acute in developing countries where external obligations are in foreign currencies. In Korea, for instance, as in Japan, corporations had traditionally pursued aggressive investment strategies with a high degree of leverage, and the government often stood as a lender of last resort to bail out their creditors. This approach was also underpinned by a strong

government guidance of private investment to avoid moral hazard, speculation, and excess capacity. However, in the 1990s when corporations were allowed to borrow freely abroad, lack of an international counterpart to the domestic lender of last resort to smooth out liquidity problems drove a number of them into serious problems, including bankruptcy (Akyüz 2000).

This is why in developing countries it is all the more important to start countercyclical policy during expansion and manage surges in capital inflows so as to prevent macroeconomic imbalances and exposure to a reversal of international capital flows.¹⁰ There are basically two broad areas of response: countercyclical macroeconomic policy, in particular monetary policy, and countercyclical adjustments in the rules and regulations applied to the financial sector, including direct or indirect restrictions over capital flows. There are difficulties in both spheres of policy and success often depends on a judicious combination of the two.

Countercyclical monetary policy

It has long been recognized that the capital account regime has important bearings on the scope and effectiveness of monetary and exchange rate policies. According to the standard economic theory, policy makers cannot simultaneously pursue an independent monetary policy, control the exchange rate, and maintain an open capital account. All three are *potentially* feasible but only two of them could be chosen as *actual* policy—thus, the dilemma known as impossible trinity. Once the capital account is opened, a choice has to be made between controlling the exchange rate and an independent monetary policy. Using monetary policy as a countercyclical tool to stabilize economic activity could result in large cyclical swings in the exchange rate and balance of payments. Conversely, if monetary policy is used to stabilize the fixed exchange rate, it cannot act as a countercyclical macroeconomic tool and prevent large cyclical swings in economic activity.

However, in most developing countries with open capital accounts, the erosion of monetary policy autonomy is often greater than is typically portrayed in economic theory. For two reasons monetary policy cannot always secure financial and macroeconomic stability whether it is geared toward a stable exchange rate or conducted independently as a countercyclical tool. On the one hand, as already noted, because of large-scale liability dollarization, there are strong spillovers from exchange rates to domestic economic and financial

conditions, and fluctuations in economic activity are increasingly associated with capital-account cycles. On the other hand, in modern financial markets the effect of monetary policy and policy interest rates on exchange rates is much more uncertain and unstable than is typically assumed in the theory of impossible trinity because of volatility of risk assessments and herd behavior. Financial turmoil hikes in interest rates are often unable to check sharp currency declines while at times of favorable risk assessment a small arbitrage margin can attract large inflows of private capital and cause significant appreciations.

Monetary policy on its own has limited scope in managing business cycles associated with surges and rapid exits of capital, in large part because domestic conditions may call for one sort of policy and international goals may call for another. This is most clearly seen at times of rapid exit of capital when monetary expansion and cuts in interest rates needed to prevent financial meltdown and to stimulate economic activity could simply accelerate flight from the currency. As a result, monetary authorities are often compelled to pursue procyclical policy in an effort to restore confidence. However, under crisis conditions the link assumed in the traditional theory between the interest rate and the exchange rate also breaks down. When the market sentiment turns sour, higher interest rates aiming to retain capital tend to be perceived as increased risk of default. As a result, the risk-adjusted rate of return could actually fall as interest rates are raised. This is the main reason why procyclical monetary policy and interest rates hikes implemented as part of IMF support during several episodes of financial crises were unable to prevent the collapse of the currency, and instead served to deepen economic contraction.

Monetary policy also faces hurdles at times of economic expansion associated with surges in capital inflows. In a high-inflation economy relying on the exchange rate and capital inflows for disinflation, there is little scope to prevent appreciations, trade imbalances, and currency mismatches in private balance sheets. This is why exchange-rate-based stabilization programs often ended in financial crises and recessions (UNCTAD TDR 2003). Neither is exchange rate floating a panacea in high-inflation economies. Prevention of appreciations, trade imbalances, and currency mismatches would call for lower interest rates to discourage arbitrage flows, but this could conflict with the objective of bringing inflation under control, particularly when disinflation relies on a strong currency to bring import costs down and to act as an anchor for inflationary expectations.¹¹ This is why countries in such circumstances tend to allow their currencies to float only upward, tightening monetary policy as soon as capital inflows show a tendency to slow down and pressure the currency to depreciate.¹²

Economies operating under a reasonable degree of price stability also face dilemmas in monetary policy at times of strong cyclical expansion associated with surges in capital inflows—a situation which has confronted some Asian economies in recent times. Tightening monetary policy in order to check asset price bubbles and overheating could encourage external borrowing and short-term arbitrage flows while lower interest rates would discourage such flows but lead to domestic credit expansion and overheating. A way out could be to employ countercyclical tightening while intervening in the foreign currency market and sterilizing its impact on domestic liquidity by issuing government debt. Intervention and sterilization can succeed when capital inflows are moderate in size and concentrated in the market for fixed-income assets. However, under strong surges across various segments of financial markets, sterilization could result in higher interest rates, attracting even more arbitrage flows. Furthermore, since interest earned on reserves is usually much lower than interest paid on public debt, there will be fiscal (or quasi-fiscal) costs, which can be large when interest rate differentials are wide and the surge in capital inflows is strong.¹³

There are less costly methods of sterilization, such as raising the noninterest-bearing reserve requirements of banks. This would also increase the cost of borrowing from banks, thereby checking domestic credit expansion. However, it could also encourage firms to go to foreign creditors. Banks may also shift business to offshore centers and lend through their affiliates abroad, particularly where foreign presence in the banking sector is important. A certain degree of control over the banking system would thus be needed to prevent regulatory arbitrage and reduce the cost of intervention.

During the surge in capital flows before 2008, several developing countries have intervened in currency markets to absorb excess capital inflows and avoid appreciations. Evidence suggests that sterilized intervention has generally been more successful in emerging markets than in advanced countries, particularly where a more strategic approach is followed in integration with global capital markets and financial deregulation.¹⁴ In China, intervention not only has been successful in managing the exchange rate but is also less costly because of the close control that the government has over the banking system. This is also true for several other countries in Asia, including those hit by the 1997–1998 crisis, which have returned to quasi dollar pegs, stabilizing their currencies within relatively narrow margins, even though their task has been less difficult because of the moderate size of capital inflows and smaller current account surpluses.¹⁵ There have also been examples of successful intervention in other parts of the developing world where capital inflows were relatively small.¹⁶

When successful, interventions in foreign exchange markets serve to prevent currency appreciations and deteriorations in the trade balance, and in doing so they reduce the likelihood of currency turmoil and the extent of payments adjustment needed in the case of such an event. But they do not prevent build up of currency mismatches in private sector balance sheets and their exposure to currency turmoil in the event of an external shock and contagion. This calls for effective measures to control and regulate international capital flows.

Prudential regulations, capital controls, and risk management

There is a consensus that prudential regulation and effective supervision of financial institutions play a key role in reducing the likelihood of financial crises and building safeguards in the event of their occurrence. These aim at ensuring the solvency of financial institutions by establishing adequate capital requirements, appropriate standards for risk assessment and diversification, sufficient provisions for nonperforming and questionable portfolios, and adequate levels of liquidity to address maturity mismatches between their assets and liabilities.

Since a large part of cross-border and cross-currency operations are intermediated by domestic financial institutions, notably banks, many prudential measures are considered as part of indirect and market-based controls over inward and outward capital flows and dollarization of assets and liabilities. In this sense, capital control measures cannot always be distinguished from prudential policies, and several measures that normally come under prudential policies can in fact be used for managing capital flows.

This position is sometimes taken to extremes by arguing that capital account liberalization should not be a cause for concern if it is accompanied by stronger and more comprehensive prudential regulations and effective supervision designed to manage the risks associated with international capital flows and to limit the vulnerability of the economy by discouraging weak credit evaluation and excessive risk-taking in borrowing and lending in foreign currencies. There are, however, limits to what prudential regulations can do in preventing instability, particularly in the face of macroeconomic shocks. Furthermore, it is not always possible to control capital flows through prudential measures because they are not always intermediated by the domestic financial system—for instance, when local firms directly borrow or invest abroad, or nonresidents enter domestic securities markets.

Many of the traditional risk assessment methods and prudential rules, including Basel I and Basel II, can serve to amplify cyclicity. This is clearly the case for loan-loss provisions based on current rates of loan delinquency. At times of boom, when asset prices and collateral values are rising, loan delinquency falls and results in inadequate provisioning and overexpansion of credit. When the downturn comes, loan delinquency rises rapidly and standard rules on provisions can lead to a credit crunch. Similar difficulties also apply to capital charges. Banks typically lose equity when an economy is hit by a massive exit of capital, hikes in interest rates, and declines in the currency. Enforcing capital charges under such conditions would only serve to deepen the credit crunch and recession.¹⁷

It is possible to design prudential regulations in a countercyclical fashion to make them act as built-in stabilizers and reduce the cyclicity of the financial system.¹⁸ Forward-looking rules may be applied to capital requirements in order to introduce a degree of countercyclicity. This would mean establishing higher capital requirements at times of financial booms, based on estimation of long-term risks over the entire financial cycle, not just on the actual risk at a particular phase of the cycle. Similarly, not current but future losses can be taken into account in making loan-loss provisions, estimated on the basis of long-run historical loss experience for each type of loan. Again, long-term valuation may be used for collaterals in mortgage lending in order to reduce the risks associated with ups and downs in property markets. Finally, other measures affecting conditions in credit and asset markets, such as margin requirements, could also be employed in a countercyclical manner, tightened at times of boom, and loosened during contractions. While useful in containing the damage that may be inflicted by financial crises, none of these measures could adequately deal with the risks associated with sharp swings in capital flows and exchange rates or prevent crises.

There have been only a few attempts in emerging markets to curb surges in capital inflows by countercyclical tightening of restrictions. In 1994, Malaysia imposed direct quantitative restrictions on acquisitions of short-term securities by nonresidents and research suggests that these were effective in improving the external debt profile, preventing asset-price bubbles, and allowing greater space for macroeconomic policy. By contrast Chile used a price-based measure, unremunerated reserve requirements, in a countercyclical manner, applied to all loans at times of strong inflows in the 1990s, but phased out when capital dried up at the end of the decade. This was also effective in improving the maturity profile of external borrowing, but not in checking aggregate capital inflows, appreciations, and asset-price bubbles.

A problem with introducing *ad hoc* countercyclical capital control measures is that they can trigger adverse reaction from financial markets, leading to sharp falls in stock prices and causing concern among governments. This was the case in Thailand when a 30 percent reserve requirement was imposed at the end of 2006 on capital inflows held less than 1 year, including portfolio equity flows, in order to check continued appreciation of the currency. This provoked a strong reaction from the stock market, forcing the government to exempt investment in stocks from reserve requirements—something that was portrayed as a retreat in the financial press. More recently, in October 2007, the proposal by the Securities and Exchange Board in India to restrict foreign buying of shares through offshore derivatives resulted in a plunge in shares and suspension of trade, to recover only after a plea for calm from the government.

The adverse market reaction to the introduction of countercyclical restrictions could be much more dramatic in countries with large stocks of foreign debt, weak current account positions, and a high degree of dependence on foreign capital. This is why governments in such countries are inclined to allow in speculative, short-term capital even when they are aware of their potential risks. For these reasons it might be more effective to have a permanent system of control in place, with instruments being adjusted according to cyclical conditions.

When capital inflows are excessive, it is also possible to adjust the regime applicable to resident outflows in order to relieve the upward pressure on the currency. Chile followed this path in the 1990s for direct investment abroad. More recently, China took a decision to permit investment by its residents in approved overseas markets for mitigating the pressure for appreciation. Such a policy response is, in fact, an alternative to sterilization intervention, but does effectively nothing to prevent currency and maturity mismatches in balance sheets. Besides, once introduced for cyclical reasons they cannot be easily reversed when the conditions change. Therefore, regulatory measures on outflows by residents should also be a part and parcel of the overall capital account regime, adjusted, rather than introduced, on cyclical basis.

Reserve accumulation as self-insurance: Burden or blessing?

Traditionally, reserves covering 3 months of imports were considered adequate for addressing the liquidity problems arising from time lags between payments for imports and receipts from exports. The need for reserves was also expected to

lessen as countries gained access to international financial markets and became more willing to respond to balance of payments shocks by adjustments in exchange rates. However, capital account liberalization in developing countries and their greater access to international financial markets has produced exactly the opposite result. International capital flows have no doubt allowed running larger and more persistent current account deficits beyond the levels that could be attained by relying on international reserves. But this has also resulted in an accumulation of large stocks of external debt. The debtor countries have thus become increasingly vulnerable to sudden stops and reversals in capital flows, and this increased the need to accumulate reserves to safeguard against currency turmoil and speculative attacks. This has become all the more apparent after the East Asian crisis where the level of reserves was generally adequate to meet current account needs, but fell far short of what was needed to stay current on debt servicing and to maintain an open capital account. On the other hand, even though many emerging markets have adopted more flexible exchange rate regimes after the 1990s, the “fear of floating” has continued unabated, with central banks using reserves to reduce short-term volatility.¹⁹

One of the lessons drawn from the Asian crisis by emerging markets was thus that they should have adequate reserves to cover their short-term debt—debt with the remaining maturity of up to 1 year.²⁰ The IMF has also urged emerging markets to hold sufficient reserves to reduce their vulnerability. Developing countries have also been advised to reduce short-term debt and/or maintain contingent credit lines with international banks—that is, to arrange a private lender-of-last-resort facility—to be used in the event of a speculative attack (Blöndal and Christiansen 1999; Feldstein 1999). The latter, on the one hand, is often seen as an unpractical and insecure way of safeguarding against external financial instability in view of the size of the amounts involved and the procyclical behavior of financial markets. Indeed, as recognized by the IMF (1999) there is no guarantee that funds will actually be available when there is a massive withdrawal of foreign investment and lending; and even if they are available, the funds provided may merely offset reduced access to normal credits. Reducing short-term debt, on the other hand, necessitates control over private sector borrowing abroad but, as already noted, this is not favored by most countries.

A problem in determining the adequate level of reserves is that vulnerability to withdrawal of funds is not restricted to short-term debt. What matters in this respect is liquidity rather than maturity of liabilities. A run by nonresidents away from domestic equity and bond markets could also create significant currency

turbulence even though in such cases asset price declines shift the losses to lenders and investors and mitigate the pressure over the exchange rate. The impact on the currency could be particularly strong when bond and equity markets are large and foreign presence is significant. Much the same is true if the economy is highly dollarized financially.²¹ A shift to foreign deposits by residents as a result of loss of confidence in the domestic currency and/or a bearish mood in the domestic securities markets could result in considerable currency instability and require large-scale interventions.

A policy of accumulating reserves at times of strong capital inflows and using them during sudden stops and reversals appears to be a sensible countercyclical response to instability in international capital flows. By intervening in the foreign exchange market and accumulating reserves, a country facing a surge in capital flows can both reduce its external vulnerability by preventing appreciations and trade deficits, and secure insurance against speculative attacks. Such a strategy, however, lacks a strong rationale since it implies that a country should borrow only if the funds thus acquired are not used to finance investment and imports, but held in short-term foreign assets. This is all the more so because, as already noted, reserves accumulated by borrowing abroad are highly costly. There are basically two types of costs involved, both of which fall on the public budget. First, there would be a net transfer of resources abroad since the return on reserves is less than the cost of external borrowing. Second, there is a transfer from the public to the private sector by the amount of the difference between the cost of sterilization and the cost of private borrowing abroad.²²

When capital inflows are in the form of nonresident investment in domestic currency debt (i.e. when interest arbitrage is undertaken directly by nonresidents), the entire margin between domestic rates on government debt and the return on reserves would be a net transfer abroad. Indeed, in recent years a growing part of domestic-currency sovereign debt of emerging markets has come to be held by nonresidents, including hedge funds, as international investors have become more willing to assume the currency risk to benefit from considerably higher interest rates in emerging markets. Some countries have also started to issue local-currency-denominated global bonds at rates below those in domestic markets because of lower jurisdiction spreads, but above the rates on foreign currency debt.²³

Clearly, such portfolio inflows are seen as particularly attractive in many developing countries because the exchange rate risk is borne by nonresidents. However, for the same reason, borrowing is more costly in local than in foreign currency. Besides, the interest differential is not always offset by currency

movements—that is, uncovered interest parity does not hold. This is because when capital inflows are large, it would be difficult to avoid nominal appreciations so that the cost of reserves can even be higher than that indicated by the margin between the interest rate on domestic debt and the return on international reserves.²⁴

For reserves earned through current account surpluses, their opportunity cost is the return on alternative forms of investment. When the economy is growing below its potential, a high level of reserve holding as an insurance against external vulnerability would entail significant opportunity costs since these resources could be used for imports, investment, and growth.²⁵ When the economy is already investing a large proportion of its income and sustaining a high growth rate, return on alternative investment opportunities abroad, such as acquisition of equity, may provide a more appropriate measure of the opportunity cost of holding reserves. However, in this case there is also a broader issue of whether it is efficient to sustain such a high savings ratio and generate large current account surpluses.

Thus, while reserves in developing countries have been rising in recent years for self-insurance, there is considerable diversity regarding their size, sources, and costs. Countries with current account surpluses are translating most or all of these surpluses into international reserves at relatively high opportunity costs in terms of growth or return on investment in alternative assets. Those with weak growth and balance of payments, notably in Latin America, are compelled to absorb net capital inflows into low-yielding reserve assets rather than using them for investment and growth. Many poor countries are unable to accumulate adequate reserves because they do not have access to capital markets or cannot run current account surpluses, thereby remaining vulnerable to trade shocks. Finally, some countries lack self-insurance and are exposed to sudden stops because large amounts of capital received have been absorbed by current account deficits that these inflows helped to generate by appreciating the currency.

Multilateral lending and countercyclical policy

Many of the difficulties faced by national policy makers in sustaining stability and a high level of economic activity in the face of balance of payments shocks were recognized by the architects of the postwar international economic system. These difficulties all had become apparent during interwar years when countries facing shortages of international liquidity had been compelled to

resort to beggar-my-neighbor trade and exchange rate practices in order to avoid deflationary adjustment, thereby causing frictions in international economic relations and contraction in trade and employment. The postwar international financial architecture was designed to avoid the repetition of this experience, based on three central components: restrictions over short-term capital flows, multilateral discipline over exchange rate policies, and provision of adequate international liquidity. The IMF was created to oversee stability of international exchange and payments and provide international liquidity to countries facing temporary balance of payments deficits in order to avoid deflationary adjustments and *ad hoc* and discriminatory trade and exchange restrictions. Although the main objective was to secure orderly payments and exchange rates among industrial countries, the responsibility for addressing the problems associated with fluctuations in foreign exchange receipts of developing countries also fell under the IMF's role for the provision of international liquidity. Unfortunately, over time, IMF has departed significantly from its original mandate.

From countercyclical financing to procyclical conditionality

The past 60 years have seen a steady distancing of the IMF from its original modalities in the provision of financing in two respects. First, automaticity in drawing on Fund's resources has been abandoned and replaced by conditionality. The Articles in their original form did not make any reference to conditional drawing within the limits of members' quotas. Conditionality has been introduced by subsequent decisions by the Board and, eventually, by an amendment of the Articles in 1969 and combined with phased drawing through tranches for better enforcement of conditions attached to drawing beyond the reserve tranche. As argued by Helleiner (1999: 7) the Fund thus moved away from provision of liquidity, that is finance available on short notice and virtually unconditionally, toward finance supplied on the basis of negotiated conditions and made available through successive tranches.

Secondly, the content of Fund's conditionality has drastically changed and the balance between financing and adjustment has tilted toward the latter. Fund programs have almost invariably contained procyclical policy measures for adjustment to payments imbalances not only when these were due to excessive domestic absorption or exchange rate misalignments, but also when they resulted from terms-of-trade shocks, hikes in international interest rates, or adverse trade measures introduced by another country. The distinction between temporary

and structural disequilibria has become blurred, and the Fund programs have come to be built on the premise that a developing country should interpret every positive shock as temporary and thus refrain from using it as an opportunity for expansion, and every negative shock as permanent, thus adjusting to it by cutting growth and/or altering the domestic price structure.

Procyclical policy conditionality has applied not only to normal drawings from the Fund, but also to various facilities introduced to help overcome specific temporary payments difficulties faced by the members. For example, a Compensatory Financing Facility (CFF) was introduced in the early 1960s as a result of a UN initiative to enable countries facing temporary shortfalls in primary export earnings to additionally draw on the Fund over and above their normal drawing rights, without the performance criteria normally required for upper credit tranches (Dam 1982: 127–128). However, the semiautomaticity enjoyed by members in their access to this facility was effectively removed by a subsequent decision of the Fund (Dell 1985: 245).

Much the same is the case for the Exogenous Shock Facility introduced in 2006 for low-income countries. This was designed to provide short-term assistance to address temporary balance of payments needs arising from exogenous shocks, including natural disasters. It is a high conditionality facility with access requiring macroeconomic adjustment—something that actually contradicts the underlying rationale of introducing such a facility which should in fact aim at preventing contractionary adjustments to temporary shocks.

There has been no initiative to introduce similar global countercyclical facilities in the past three decades despite periods of widespread difficulties in the world economy, including global contraction in income and trade in the early 1980s and the threat of serious disruption to international trade and payments after the East Asian and Russian crises in the 1990s.

Crisis lending: Current-account financing or financial bailouts?

Perhaps an even more fundamental shift in the role of the Fund in multilateral lending is that it has become a crisis lender and manager for emerging markets. Under the Bretton Woods system where private capital flows were relatively insignificant, the amount of deficits that countries could run was restricted (except for the United States) to their reserve holdings. Thus, when they went to the Fund for liquidity, the official financing needed was relatively small and could be accommodated by their quota-based drawings. However, as already noted, with rapidly increased private capital flows and capital account opening,

it has become possible to run much larger deficits than made possible by reserve holdings and for much longer periods. But since capital flows are subject to boom–bust cycles, the amount of official financing needed to stabilize the exchange rate at times of sudden stops and reversals far exceeds the volume of official liquidity that would be available on the basis of regular credit tranches. Under these conditions, prevention of default would necessitate exceptional access to Fund's resources over and above quota-based drawing.

The role of the Fund as a lender and manager of capital account crises in emerging markets effectively started with the outbreak of the debt crisis in the early 1980s when “many developing countries borrowed heavily from multilateral sources in order to finance debt servicing to private creditors” (Sachs 1998: 53). Such lending has effectively become the dominant financial activity of the Fund after recurrent crises in emerging markets in the 1990s.

There are, however, serious difficulties in transforming the IMF into a genuine international lender of last resort. The effective functioning of such a lender depends on two conditions: it should have the discretion to create its own liquidity (or to have unconstrained access to international liquidity), and there should be reasonably well-defined rules and conditions that the borrower must meet. Strictly speaking, the IMF, as it stands, does not satisfy either of these conditions to qualify as a lender of last resort. However, it is in principle possible to overcome the resource constraint by allowing the Fund to issue reversible SDRs to itself for use in lender-of-last-resort operations; that is to say the allocated SDRs would be repurchased when the crisis was over (Ezekiel 1998).

The terms of access to such a facility could pose even more serious problems. A genuine lender-of-last-resort ready to lend in unlimited amounts without conditions except at a penalty rate would need to exercise a tight supervision over borrowers to ensure their solvency. But this is not easy to reconcile with sovereignty. While automatic access would ensure a timely response to market pressures, it would also create moral hazard for international borrowers and lenders and considerable risk for the IMF. By contrast, conditional withdrawal of financial support and a degree of “constructive ambiguity” would reduce the risk of moral hazard, but negotiations could cause long delays, perhaps leading to a deepening of the crisis.

Prequalification is often seen as away out: that is, countries meeting certain *ex ante* conditions would be eligible for lender-of-last-resort financing with eligibility determined, for instance, during Article IV consultations. Under such an arrangement, automatic access to the lender-of-last-resort facility on a prequalification basis could be subject to limits but, after a crisis occurred, the

country might receive additional funds subject to its commitment to undertake certain actions.

However, prequalification involves its own set of problems. First, IMF would have to act like a credit-rating agency. Second, the result could be a further segmentation of the Fund's membership, with attendant consequences for its governance. Third, lending at penalty rates might not be enough to avoid debtor moral hazard. Finally, it would be necessary to constantly monitor the fulfillment of the terms of the financing, adjusting them as necessary in response to changes in conditions (which might include those in financial markets or others beyond the control of the government of the recipient country). In these respects, difficulties may emerge in relations between the Fund and the member concerned.²⁶

A fundamental flaw of the IMF's policies of crisis prevention is related to its approach to capital inflows. As recognized by the Independent Evaluation Office in a report on the IMF's approach to capital account liberalization, the Fund was ambivalent about controls over capital inflows, including market-based measures such as un-remunerated reserve requirements applied by Chile (IMF/IEO 2005: 60). It abstained from recommending controls even when surges in short-term capital were leading to sharp currency appreciations and growing trade deficits, advocating, instead, fiscal tightening, and greater exchange rate flexibility.

The objective of maintaining open capital account not only for inflows at times of surges, but also for outflows during exits underpins the initiatives undertaken for the provision of exceptional financing since the East Asian crisis, including the Supplementary Reserve Facility (SFR), Contingent Credit Line (CCL), and the Reserve Augmentation Line (RAL). The moral hazard implications of these facilities—namely that they tend to encourage imprudent lending and investment practices, adding to bubbles—are generally recognized, particularly for international creditors and investors. The debtor moral hazard is less of a problem since it must be now evident that the IMF bailout operations do not prevent financial meltdown and recessions. These facilities not only allow the creditors and investors to escape the full consequences of the risks they have assumed and, hence, weaken market discipline, but also place a disproportionate burden on debtors who not only pay a hefty risk premium on inflows but also penalty rates for IMF funds in order to finance outflows.

Creditor moral hazard, inequitable sharing of the burden of a crisis between debtors and creditors, and the inadequacy of the level of lending to forestall speculative attacks all render exceptional IMF facilities rather poor instruments for crisis prevention and intervention. By comparison, capital account policies

could present themselves as more viable alternatives, at times of both surges and exits. Countries have the scope to regulate capital inflows at times of surges and reduce their exposure. But without a multilateral framework it is considerably more difficult to impose control over outflows during sudden stops and reversals, and prevent financial crises and recessions.

After recurrent financial crises in the 1990s, there was indeed a growing consensus on the need to limit Fund bailout operations and introduce multilaterally agreed debt workout procedures in order to overcome moral hazard and involve the private sector in resolution of financial crises.²⁷ The IMF Board also recognized that at times of rapid outflows a need might arise for a unilateral standstill and comprehensive capital controls even though it was unwilling to provide statutory protection to debtors in the form of a stay on litigation, preferring instead signaling the Fund's acceptance of a standstill by lending into arrears to private creditors.²⁸ The secretariat took an initiative and proposed the Sovereign Debt Restructuring Mechanism (SDRM). However, this was designed to address the problem of sovereign insolvency; it would apply only to countries with unsustainable sovereign external debt, while those facing liquidity problems would continue to receive IMF support. The provision for statutory protection in the form of a stay on litigation was dropped to increase the likelihood of its acceptance. However, even this diluted version of the SDRM proposal could not elicit adequate political support and was abandoned.

Areas of reform

The guiding principle of any reform of IMF financial operations should be the following. The Fund lending should focus on countercyclical financing designed to support economic activity, trade, and employment in countries facing foreign exchange shortages due to trade and financial shocks, and the Fund should refrain from lending to support repayment to international creditors, and investors in developing countries. Even when capital account crises in emerging markets pose a systemic threat to international financial stability, the problem should not be addressed by the IMF, but by the governments of major countries hosting creditors and investors—as they did in the Long Term Capital Management debacle in the aftermath of the Russian default.

This is to say that the IMF should, in principle, lend for current account financing not for capital account financing, and instability in the capital accounts of developing countries should be dealt with using other policy instruments—something that calls for a fundamental reform of the approach of the IMF to

international capital flows. Reform of multilateral arrangements regarding capital account issues should aim at widening the space for countercyclical national and multilateral policy in the presence of both positive and negative capital account shocks. As they stand, the Articles of the Fund do not give it clear and effective jurisdiction over capital account issues or allow it to include capital account measures as conditionality in its financial arrangements with a member (IMF/IEO 2005: 50). The Fund should be able to request exercise of control over inflows as well as outflows, and the guidelines for surveillance should specify the circumstances in which it can actually recommend the imposition or strengthening of the measures of control and regulation. It should also develop new techniques and mechanisms designed to separate, to the extent possible, capital account from current account transactions, to distinguish among different types of capital flows from the point of view of their sustainability and economic impact, and to provide policy advice and technical assistance to countries at times when such measures are needed.

The Articles of the IMF allow it to request members to exercise control on capital outflows, but they do not provide legal protection against litigation by international investors and creditors for countries imposing temporary standstills and exchange controls at times of rapid exit of capital.²⁹ This would require an agreement on a definitive interpretation or an amendment of the Articles of the Fund to be ratified by all members. The decision for a standstill should be taken unilaterally by the country concerned and sanctioned by an independent panel rather than by the IMF because the countries affected are among its shareholders and the Fund itself is a creditor. This would be similar to WTO safeguard provisions which allow countries to unilaterally take emergency actions to suspend their obligations when faced with balance-of-payments difficulties (Akyüz 2002: 124–125). However, the Fund should also be able to request a mandatory standstill, as well as exchange controls, when it lends into arrears if creditors are unwilling to reach an agreement on a voluntary one. This would be essential to ensure that the Fund money is not used to finance debt repayments and capital outflows.

Countries facing temporary difficulties on their current payments due to shortfalls in export earnings, surges in import prices, or hikes in interest rates should enjoy adequate access to IMF financing. Such lending should be available both to low-income countries without regular access to financial markets and to emerging markets whose access to private finance is often impaired at times of current account difficulties because of procyclical behavior of markets. Exceptional current account financing may be needed at times of a contraction

in world trade and growth, and/or sharp declines in capital flows to developing countries, as was the case in the early 1980s and after the East Asian and Russian crises. The Fund's regular resources may not be adequate for dealing with such cases because they are not large or flexible enough. This can be handled by a global countercyclical facility based on reversible SDR allocations, and countries could be permitted to have access to such a facility on a temporary basis within predetermined limits.

The level and terms of access of developing countries to IMF resources need to be reconsidered. An across-the-board increase in IMF quotas at current levels of allocation would not improve the access by many developing countries because of the small size of their quotas. Even a redistribution of quotas on the basis of income shares valued at purchasing power parities would only address a small part of the problem for low-income countries. One way would be to use different quotas for contributions and drawing rights. Different access limits may be set for different groups of countries according to their vulnerability to external shocks and access to financial markets. Under such an arrangement, specific facilities such as the CFF would no longer be needed to meet the special needs of poorer countries. Access based on need, together with an overall expansion of Fund quotas and their redistribution in favor of developing countries, would increase unconditional access through reserve tranche purchases. However, it is also important to end the tendency to impose procyclical macroeconomic conditionality at higher access levels.

There has been considerable emphasis in the recent debate on the role that may be played by the SDR in a new design of the international economic architecture. There has been no SDR allocation since 1981; the special allocation agreed by the Board in 1997 has not taken effect because it has not been approved by the United States. Various proposals have been made to revitalize and use the SDR for development assistance or a lender-of-last-resort facility, but these do not have strong rationales. International taxes on global public bads such as currency speculation, gas emissions, or arms trade provide more appropriate alternatives for development financing, and the rationale for using reversible SDR allocations for a global countercyclical facility is much stronger than using it for financial bailout operations.

It has been suggested that while the original rationale of provision of additional liquidity to the system as a whole is no longer valid, SDR allocations can yield specific "benefits of permitting low-income countries to acquire and hold reserves at a much lower interest rate than they would have to pay in the market and a reduced dependence of the system on borrowed reserves that are

liable to be recalled when they are most needed” (Polak and Clark 2006: 553). In this proposal total stock of SDRs would be limited by the amount willingly held at the SDR interest rate, and there would be no IMF designation as to which countries should hold them. This is particularly important for preventing the SDRs from becoming an instrument for financing capital outflows and repayment of creditors at times of financial turmoil.³⁰

Perhaps, one can go even further and replace quotas and General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB) with the SDR to fund the IMF. This would require the Fund to allocate SDRs to itself up to a certain limit, which may be increased over time with growth in world trade and FDI flows. The demand for SDRs can be expected to be inversely related to buoyancy in global trade and production and the availability of private financing for external payments. Thus, it would help counter deflationary forces in the world economy and provide an offset to fluctuations in private balance of payments financing.

Conclusions

Real economic activity is increasingly shaped by developments in the sphere of finance. This influence is not always benign. Contractionary and expansionary impulses emanating from the real economy are often aggravated by procyclical response of financial markets, amplifying swings in investment, income, and employment and leading to waste of resources and creating income and job insecurity. In developing countries, financial cycles are dominated by surges and sudden stops in international capital flows driven by factors largely beyond their control. Consequently, stabilization of economic activity and prevention of financial crises crucially depend on how integration with the global financial system and international capital flows are managed.

This chapter has examined policy challenges and options at the national and international level in managing financial cycles without sacrificing output and employment. A key conclusion relates to the complementarity between national and international policies. In the absence of appropriate multilateral arrangements for the provision of international liquidity and management of capital flows, the scope for national policy is quite limited and national authorities are forced into seeking suboptimal solutions to problems posed by the instability of capital flows. However, it is also true that multilateral arrangements can only support national policy rather than substitute it.

There is considerable diversity among developing countries with regard to space available for countercyclical policy in the areas of intervention examined here. The policy space is much more limited in countries with structural fiscal and current account imbalances, inadequate levels of domestic savings and investment, high stocks of public and external debt, and excessive dependence on foreign capital. These countries face serious dilemmas in reconciling domestic and external objectives in the conduct of countercyclical monetary policy. They are also more susceptible to adverse reaction of markets to various measures of control that may be imposed over capital flows.

Managing capital inflows hold the key to the prevention of capital account crises since policy options are much more restricted under sudden stops and reversals. However, the policy space available is not always exploited efficiently. Some countries still adopt an attitude of benign neglect at times of strong inflows, allowing them to generate fragility in private sector balance sheets, currency appreciations, and trade imbalances. Although many countries, notably in Asia, show increased awareness of vulnerability to capital account crises, their policy response is not always optimal. Many of them continue to allow a high degree of freedom to capital movements, and intervene in foreign exchange markets to prevent sharp appreciations and trade deficits, and accumulate reserves as a safeguard against sudden stops and reversals.

Reserve accumulation is now seen as the only reliable defense against instability of capital flows. In some countries, these are generated by cutting imports and growth. In others, including those running current account surpluses based on strong exports, an important proportion of reserves are borrowed. These entail large carry costs and transfer of resources to reserve-currency countries. Efforts to build reserves as a self-insurance by generating current account surpluses and resisting currency appreciations are also threatening to become a major source of tension in international trade.

Accumulating reserves by cutting growth, borrowing, or generating large trade surpluses by beggar-my-neighbor trade and exchange rate policies is certainly inferior to cooperative multilateral solutions to the problem of instability in private capital flows. Solutions at the multilateral level could be sought in two main areas: provision of adequate international liquidity at appropriate conditions for current account financing to countries facing foreign exchange shortages as a result of trade and financial shocks; and orderly debt workout procedures designed to stem attacks on currencies, check capital outflows, and involve the private sector in the resolution of crises. Multilateral

policy surveillance and advice should also be used to help countries to manage surges in capital inflows.

However, the multilateral system has been moving away from countercyclical financing toward procyclical policy conditionality, and from current-account financing to capital account financing. Many facilities introduced in the past to allow countercyclical policy response to temporary payments imbalances have either disappeared or have been made highly conditional on the pursuit of procyclical macroeconomic policies. IMF crisis lending has focused on the repayment of private creditors and investors and maintenance of convertibility, rather than restoration of income and employment.

The way the IMF has handled financial integration and stability of developing countries has indeed been quite abysmal, even in comparison with the muddling through the debt crisis of the 1980s, causing rapid loss of reputation and relevance for the institution. There was first an attempt to change the Articles to establish a global regime of open capital accounts, but this had to be abandoned willy-nilly after a series of crises. There followed calls for an international lender-of-last-resort as a preemptive measure, but the CCL established for this purpose proved to be deficient and had to be abandoned. Difficulties in establishing a last resort lender with adequate power of supervision over national policies and the concern over safeguarding IMF resources, aggravated by sovereign defaults in some emerging markets working with the Fund, led to an attempt to design orderly workout procedures for sovereign debt and recommendations of self-insurance. The SDRM was abandoned because of opposition from the financial markets and the United States, and lack of support among developing countries. But the advice on reserves has been taken to heart, making the Fund irrelevant for an important group of developing countries. The fate of the recently proposed RAL, as an attempt to keep the Fund in business for weaker and highly vulnerable emerging markets, is uncertain—the debate in the IMF Board indicates that there are serious concerns about its viability.

Even with the severity and reach of the current economic crisis, the prospects for reforming multilateral monetary and financial arrangements in areas crucial for financial and economic stability of developing countries are not very bright. This makes it all the more important for countries that are vulnerable to crises to be vigilant about their integration into international financial markets. In order to reduce their exposure to financial crises, they need to make full use of the policy space available and create conditions for widening their policy space by addressing their structural and institutional weaknesses.

Notes

- 1 I am grateful to Sanja Blazevic and Makameh Bahrami of UNCTAD for their assistance with the data used in this chapter.
- 2 For evidence on the procyclical effects of capital flows on economic activity in emerging markets, see Prasad et al. (2003).
- 3 A classical example is the 1992 EMS crisis which produced sharp drops in the lira and pound sterling without provoking financial crises in Italy and the United Kingdom. Similarly, at the end of the 1990s, the dollar-yen rate was seen to change by over 20 percent within a matter of a week. Such swings were comparable to those experienced in East Asia in 1997 but did not produce widespread defaults and bankruptcies. A notable exception is the 1987 stock market break which was closely linked to the instability of the dollar after the Plaza agreement.
- 4 For instance despite persistent difficulties in the financial sector in Japan throughout the 1990s, the yen saw periods of strength as well as weakness. By contrast, the recent instability of the dollar is influenced, at least partly, by the sub-prime mortgage crisis.
- 5 For firms' investment and employment decisions under uncertainty, see Dixit and Pindyck (1994).
- 6 For the evidence on the stability of investment, see UNCTAD TDR (2003) and World Bank (2003).
- 7 Here recovery refers to the phase of expansion where growth is only sufficient to make up for income losses during the preceding recession. It is jobless if the growth rate of employment is not positive.
- 8 For the evidence on the evolution of employment and wages in boom-bust-recovery cycles in emerging markets, see UNCTAD TDR (2000: chapter 4), ILO (2004), and van der Hoeven and Lübker (2005), analyzed in greater detail in Akyüz (2006).
- 9 On the view that financial stability depends on price stability, see Schwartz (1995) and Bordo and Wheelock (1998). By contrast, Borio and Lowe (2002) argue that financial imbalances and instability can emerge in a low-inflation environment.
- 10 For a lucid account of options available in responding to excessive capital inflows, see Williamson (1995).
- 11 Lower interest rates are unlikely to generate significant domestic demand pressures on prices, since in such countries business rarely borrows in domestic currency, preferring much cheaper dollar credits while assuming the exchange rate risk.
- 12 This was the Turkish response to the impact of global instability in financial markets in May-June 2006 when interest rates, almost in double-digit figures in

real terms, were aggressively raised to check the depreciation of a highly overvalued currency. This suggests that the fear of floating (Calvo and Reinhart 2002) is asymmetrical, more overwhelmingly downward than upward.

- 13 For some estimates of fiscal cost of intervention in emerging markets, see Mohanty and Turner (2006).
- 14 On the effectiveness of foreign exchange market interventions in emerging markets and the recent experience, see the articles in BIS (2005), notably Disyatat and Galati (2005) and Mihaljek (2005). For a general survey of the issues involved, see Sarno and Taylor (2001).
- 15 According to Mohanty and Turner (2006), over the period 2002–2006 most central banks in Asia eased monetary policy and lowered interest rates as they were building reserves without losing control over inflation. Nevertheless, there were still sharp increases in the supply of central bank bills, which reached 15, 20, and 30 percent of GDP in China, Korea, and Taiwan, respectively. In China where over 80 percent of central bank securities are held by banks, reserve requirements were raised from 7 percent in 2003 to 12.5 percent in 2007, and the share of central bank bills in total assets of banks more than doubled.
- 16 In Argentina, for instance, sterilization has been successful in keeping the real exchange rate within a target range and absorbing resulting excess liquidity through emission of central bank paper since 2002–2003 despite opposition from the IMF—see Damill et al. (2007).
- 17 This happened in Asia during the 1997–1998 crisis as a result of extensive efforts to strengthen regulatory regimes as part of the IMF packages of financial support—see UNCTAD TDR (1998: chapter III, box 3).
- 18 This approach is finding considerable support in the BIS (2001: chapter VII); see also Borio et al. (2001) and White (2006). For further discussion in relation to emerging markets, see Akyüz (2004).
- 19 The IMF Guidelines for Foreign Exchange Reserve Management recognize that reserves are held with a number of objectives linked to the capital account, including supporting and maintaining confidence in monetary and exchange rate policy, limiting external vulnerability, and providing confidence to markets that the country can meet its external obligations—IMF (2005b).
- 20 This has come to be known as the Greenspan–Guidotti rule. For a discussion, see UNCTAD TDR (1999: chapter V). For an attempt to empirically determine the optimum level of reserves based on welfare criteria, see Jeanne and Rancière (2006) who find that the optimal level suggested by their model is close to the Greenspan–Guidotti rule.
- 21 Financial dollarization is often measured in terms of the share of foreign currency in the total deposits of residents. This tends to be very high in emerging markets,

- reaching or exceeding 50 per cent in some—see Reinhart et al. (2003) for various concepts of dollarization, its determinants and consequences, and regional differences.
- 22 The cost incurred by the public sector on each dollar of reserves is given by $i_g - i_r = (i_g - i_x) + (i_x - i_r)$ where i_g , i_r , and i_x are the rates, in common currency, on government domestic debt, reserve holdings, and external borrowing, and typically $i_g > i_x > i_r$. When nonresident claims are only in foreign currencies, the first term on the RHS is captured by the holders of public debt at home and the second term is the net transfers abroad – what Rodrik (2006) calls the social cost foreign exchange reserves. For the distinction between the two types of transfers and costs, see UNCTAD TDR (1999: chapter V).
 - 23 On increased holding by nonresidents of locally and globally issued domestic currency debt of emerging markets, see Mehl and Reynaud (2005), De Alessi et al. (2005), Tovar (2005), and IMF (2005a). In some countries such as Turkey, nonresident holding of local currency debt has increased much faster—Yeldan (2007). Thus emerging markets have started to overcome the “original sin” at the cost of paying much higher rates.
 - 24 This has certainly been the case in Turkey over the last few years where the lira appreciated in nominal terms vis-à-vis most reserve currencies while the domestic borrowing rates stayed at around 20 percent.
 - 25 Even when reserves are borrowed, the social return on investment may exceed the cost of borrowing abroad so that insurance against vulnerability would be even more costly in terms of growth. Rodrik (2006) uses external borrowing costs in estimating the social cost of foreign exchange reserves, pointing to the difficulties in empirically measuring the social rate of return on capital.
 - 26 Such problems emerged in the Brazilian agreement with the IMF in 1999 which constituted an experiment with the provision of international lender-of-last-resort financing to an emerging market: it was intended to protect the economy against contagion from East Asia, subject to a stringent fiscal adjustment and a gradual depreciation of the *real* throughout 1999. After a political struggle, the Brazilian Government succeeded in passing the legislation needed to meet the fiscal target but, when the currency came under attack, the Fund allowed the agreement to collapse, requiring additional and more stringent conditions regarding the fiscal balance in order to release the second tranche of the package.
 - 27 See, for example, Group of 22 (1998); the Council of Foreign Relations Independent Task Force (CFRTF 1999); the Emerging Markets Eminent Persons Group (EMEPG 2001); and the High-Level Panel on Financing for Development (Zedillo 2001). For a discussion of issues in bailouts and reform, see Goldstein (2000), Haldane (1999), Akyüz (2002), and Eichengreen (2002).

- 28 See IMF (2000). For further discussion of the debate in the IMF, see Akyüz (2002: 123–128).
- 29 On conflicting interpretations of IMF provisions and judicial practices, see UNCTAD TDR (1998: chapter V).
- 30 A further issue discussed by the authors is whether allocation should be made to all members or to low-income members alone. They advocate retaining the provision of the Articles which implies that the size of a member's allocation should not be based on the state of its payments position. This could further meet the concern expressed here that the SDR should not become an instrument of financial bailouts.

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