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Summary record of the 28th meeting

Held at Headquarters, New York, on Tuesday, 4 November 1997, at 3.30 p.m.

Chairman: Mr. de Rojas . . . . (Venezuela)

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The meeting was called to order at 3.50 p.m.

Agenda item 95: Macroeconomic policy questions (continued)

(a) Financing of development, including net transfer of resources between developing and developed countries (continued)

(b) Trade and development (continued)

Panel discussion on financial and development issues in emerging markets

1. Mr. Ahmed (Associate Administrator, United Nations Development Programme (UNDP)), acting as moderator, introduced the panellists: Mr. Buira (Banco Nacional de México), Ms. Lim (University of Michigan) and Mr. Sengupta (Indian Planning Commission).

2. Mr. Buira (Banco Nacional de México) said that, in a country faced with the dilemma of whether to "sterilize" monetary expansion resulting from a surplus in its balance of payments or to allow monetary aggregates to expand as a result of capital inflows, complete sterilization would mean the total re-export of such capital through an increase in its central bank's international reserves. The consequences of adopting such a policy would be that incoming foreign capital could not be used to supplement investments in the country. Another factor to be considered was that the central bank would issue domestic liabilities at high interest rates in order to acquire the excess supply of foreign exchange and thus might incur substantial losses, since the interest payments on those liabilities were normally higher than the yield on foreign exchange invested abroad. Therefore, if capital inflows were to be used to increase the productive capacity of the economy, at least a part of such inflows must be monetized since monetization tended to increase expenditure and also contributed to an increase in imports.

3. At the same time, there were good reasons to conduct partial sterilization of capital flows. First, the flow of foreign investment could be reversed, and it was therefore useful to accumulate sufficient international reserves to counteract possible capital outflows. Secondly, if capital inflows were very large, a country might be faced with an excessive increase in aggregate demand, which would produce unacceptable inflationary pressures. Thirdly, a case could be made for the imposition of liquidity requirements and limits on bank foreign-currency liabilities in order to discourage excessive short-term borrowing by commercial banks.

4. In the absence of macroeconomic imbalances and distortions in relative prices in the economy, capital inflows were beneficial since they supplemented domestic savings and, consequently, allowed a greater amount of investment or, more generally, a greater volume of consumption and investment. New investment opportunities increased an economy's absorptive capacity. Countries that received private capital inflows were usually countries that had undergone structural transformations that improved the medium- and long-term prospects for their economies.

5. At the same time, policy makers had expressed concern at the real exchange-rate appreciation produced by capital inflows and its impact on the competitiveness of the export sector, and doubts about the sustainability of the inflows. Such concerns had often led countries to impose a tax on capital imports, which seemed to be effective only in the short term; to adopt trade-policy measures in order to insulate the export sector from real exchange-rate appreciation; to engage in further fiscal tightening so as to lower aggregate demand and curb inflationary pressures; to sterilize monetary expansion in spite of the potentially high quasi-fiscal losses that it tended to create; and to increase marginal reserve requirements on foreign inflows.

6. While large current-account deficits could be financed for prolonged periods, such deficits significantly increased the vulnerability of a country's economy to variations in international capital flows. When an important part of the funds used to finance the deficit was composed of short-term volatile resources, vulnerability was even greater. Although determining what was a sustainable deficit might not be an easy task, awareness of that vulnerability could lead authorities to limit the current deficit to a certain level.

7. A country that was attractive to foreign investors was faced with a paradox: as inflows eventually translated into a growing current-account deficit, the same investors who had been eager to bring in their capital might look at the size of the deficit and withdraw their funds, thereby precipitating a payments crisis. Thus, as capital inflows gave rise to a current-account deficit, they ironically became the country's weakness. Moreover, vulnerability was compounded when domestic financial institutions were themselves weak and unable to withstand a major reversal of capital flows. Reducing a country's exposure to the volatility of external capital while sustaining a healthy level of investment required an increase in national savings. One way to accomplish that would be to develop pension programmes.

8. The liberalization of cross-border flows had led to the internationalization of investments by institutional funds. That had generated a large supply of funds that tended to be yield-sensitive and that responded swiftly to changes in sentiment about recipient economies. Abrupt and massive changes in

capital flows left policy makers and private agents very little time to adjust. The December 1994 devaluation of the Mexican peso had resulted in a liquidity crisis of huge proportions as capital flows had been not only interrupted but reversed. The Bank of Mexico had now imposed a limit on the foreign-currency denominated liabilities that commercial banks could take on.

9. Measures to discourage short-term capital, including the adoption of a floating exchange rate, might be seen as a means of reducing the risks of a large current-account deficit and of neutralizing the effect of market imperfections. In the event of capital withdrawal, a difference might arise between individual and social costs. While an investor might bear a market-imposed reduction in the value of his investment in an emerging market, which often accounted for a small proportion of his portfolio, a massive capital outflow might cause the financial collapse of an economy.

10. The Mexican crisis had raised a number of issues for developing countries that had undertaken internal reforms and external opening. Such countries had to consider how best to determine what constituted the danger level for the current-account deficit; what were the appropriate policies for coping with short-term capital movements and a sudden change in market sentiment; how to distinguish between temporary and permanent shocks; whether the blanket removal of restrictions on capital inflows was always a good thing or whether certain conditions should be met before capital flows were fully liberalized; whether it was possible to sterilize massive capital inflows or whether a country could be expected to offset capital inflows by running large fiscal surpluses. Financial markets were currently able to condition and modify national economic policies and could force exchange-rate adjustments or even impose a change of the exchange-rate regime; they could also increase the volatility of the prices of financial assets, generating or increasing imbalances that might lead to inflation and recession. Financial markets could transmit tensions from one market to another, increasing the probability of systemic risks for which the world was not yet prepared. There had been a shift of power from Governments to the markets. Over the past few weeks the turmoil in South-East Asian financial markets, in particular those of Hong Kong, had demonstrated that sound economic policies were not of themselves sufficient to ensure stability and protect a country from a financial crisis.

11. Under current arrangements, access to liquidity was concentrated in industrial countries and a few developing countries. At the end of 1995, 22 industrial countries and 18 developing countries with access to international capital markets controlled 91 per cent of international reserves. The remaining 145-odd countries, held a very low share of total world reserves and had little access to private international financing. As a result, they were forced to acquire more adequate reserves through extensive borrowing on the market – in the few cases where markets were prepared to lend to them – or through compression of domestic demand for input, which would be inimical to their reform and growth efforts. Developing economies with limited or no access to financial markets were unable to exploit their growth potential because of a lack of liquidity, and were forced to rely almost exclusively on exports to meet their liquidity needs. Moreover, those countries did not have a diversified export base and were very vulnerable to fluctuations in commodity prices. Thus, a lack of liquidity introduced a deflationary bias in the performance of developing countries and, through lower international trade, on that of the world economy. That was inconsistent with the Articles of Agreement of the International Monetary Fund (IMF). Unfortunately, the Fund had not played a role in creating and distributing international liquidity.

12. In spite of the acceptance of the objective of making special drawing rights (SDRs) the principal reserve asset of the system, SDRs as a proportion of world reserves had declined from 4.5 per cent of the total in 1975 to around 1.5 per cent in 1997. A few weeks earlier, at its annual meeting, the IMF Board of Governors had agreed on a proposal for a one-time special allocation of SDRs of $21.4 billion, which would raise the amount of SDRs to a total of $42.9 billion. However, those SDRs would not be distributed according to quotas, as the Articles of Agreement required, but would be allocated on so-called equity grounds, mostly to the former Soviet Union and Eastern European countries, a group of largely middle-income countries. For a large number of countries, insufficient liquidity required the adoption of restrictive economic policies.

13. The process of financial innovation and deregulation and liberalization of financial markets throughout the world had led to more integrated and globalized capital markets. In addition, technological advances had increased the speed at which financial transactions took place. As a result, the amount of capital trade on international markets had surged in recent years. However, markets had shown a tendency towards major fluctuations, which posed new and difficult challenges for financial authorities and for the international community. Thus, one could well ask whether, in current conditions, the full liberalization of capital movements was an appropriate measure.

14. Capital flows to emerging economies were often volatile for reasons that bore little relation to country risk. Industrial countries normally formulated their policies based on their own domestic considerations with little regard for the

international repercussions of their actions. On several occasions, that had led to much higher levels of real interest rates and exchange-rate fluctuations, which had increased the cost and diminished availability of international financing to developing countries. Capital flows and commercial bank lending had been cyclical. Capital flows were at their highest when economic and business prospects were good, but tended to decline when the economy slowed down or when problems or uncertainties of any kind appeared. Thus, capital markets themselves tended to undermine the countries' credit-worthiness.

15. Market behaviour was often characterized by information asymmetries and contagion effects. Country-risk analysis was often dominated by herd behaviour. Recent episodes of financial-market turbulence had shown that a country could lose its credit-worthiness overnight. In some cases, such a loss of credit-worthiness was justified. However, countries could face abrupt changes in the cost and availability of liquidity when unexpected events triggered shifts in market sentiment, creating a strong need for additional reserves. In many cases, the process of restoring credit-worthiness was unduly delayed, since investors tended to wait for the country to recover. Official agencies, regulating banks and existing official credit and rating agencies could help but they sometimes monitored a country's compliance with a programme for a year or more before revising their appraisals.

16. The new challenges posed by the growth and liberalization of financial markets called for a parallel development of international financial institutions capable of acting as overseers and, if and when appropriate, as regulators of international flows. The risks arising from the volatility of capital, which were currently assumed, for the most part, by recipient countries, must be more widely shared, especially by investors. Investors must be made aware of the impact that their actions had on a country's economy, and provided with incentives to act responsibly. That could mean that, if a sudden and massive reversal of capital flows caused a major financial crisis in a country, the authorities, in consultation with and possibly under the supervision of IMF, should impose certain limitations on capital withdrawals. In addition, the Fund should be in a position to act as a lender of last resort to countries facing speculative attacks.

17. Undoubtedly, increased capital flows were a recent phenomenon that called for increased financial support from the Fund. That would be consistent with the purposes of the Fund and, in particular, with the provisions of article 1 of the Articles of Agreement. Developments along those lines would enable the world to benefit fully from the considerable contributions that international capital flows could make to development financing while minimizing the risks posed by unbridled speculative capital movements to recipient countries.

18. Ms. Lim (University of Michigan) said that the countries of South-East Asia included some of the most open economies in the world where foreign direct investment over the past 30 years had fuelled remarkably rapid growth and access to foreign markets. While there might be some merit to criticisms regarding, for example, their over-dependence on readily available foreign capital, the wasteful use of funds by both Governments and private corporations in the region or the over-eagerness of foreign capital itself to lend on fairly flimsy criteria, foreign capital alone was not to blame for the ongoing South-East Asia currency crisis and the ensuing economic slowdown. Governments and corporations were equally to blame. When the United States dollar had started appreciating against the yen, Governments had failed to tighten domestic fiscal and monetary policies, while corporations had failed to hedge their dollar loans because of the high interest costs involved. The result had been ballooning current-account deficits and the slowing down of capital inflows as export and asset competitiveness had eroded with increasingly overvalued currencies. Cautious short-term investors had withdrawn their funds and currency traders had launched attacks on the Thai baht because Thailand was the weakest country in terms of economic and political fundamentals. Following the baht's fall, speculators had turned to other currencies in the region which exhibited many of the same weak fundamentals. While some depreciation had been expected in the currencies of other countries of the region, their persistent and continued decline beyond the expected 10 to 25 per cent levels, the rate of appreciation of the dollar against the yen, was surprising. South-East Asian currencies were now undervalued by as much as 40 to 50 per cent.

19. Rapid recovery appeared unlikely, mainly because of the slowness of some Governments to undertake the appropriate fiscal and monetary measures and the effect of external shocks but also because speculators had lost confidence in the region's currencies. Those developments demonstrated, *inter alia*, that Governments needed to manage their own fiscal and monetary policies to ensure that exchange rates were credible, and that private financial and industrial companies needed to manage their loans better. Such policies were necessary to ensure financial stability and promote the efficient utilization of capital.

20. Market imperfections were exacerbated in many developing countries by such factors as cronyism, lack of skills and transparency and also information gaps, which made it difficult for market actors to properly assess risks and

returns. In an increasingly integrated world economy, the margin for error by both market actors and Governments was much smaller and the risk of contagion to other economies was greater. That was why there was a need to impose some discipline on regional as well as global private financial flows.

21. The South-East Asian experience showed that while capital market liberalization was beneficial in the long run to the economic development of developing countries, such liberalization should not proceed until the proper institutional bases had been laid and the necessary skills developed. Otherwise, liberalization and growth were likely to be interrupted and restrained by the cost of increased risk and volatility. Globalization must benefit everyone, especially the developing countries. The remedy lay not in turning away from the world but in embracing it even more closely.

22. Mr. Sengupta (Indian Planning Commission) recalled that private capital accounted for an increasingly large proportion of foreign capital flows. Therefore, if the international community wanted to provide more funding to developing countries, it must devise methods to increase private capital flows to those countries and also learn how to manage such flows. What had happened in Mexico and in South-East Asia made that very clear. According to all the so-called macroeconomic fundamentals of the international monetary system, the South-East Asian countries had been doing extremely well and satisfied all the criteria of good governance. Yet because of their confidence in those countries' economies and ability to pay, private investors had extended loans to them without inhibition. There probably had been some over-borrowing, particularly short-term borrowing, but it was hard to tell when exactly the level of borrowing had passed the limit of prudence. It was also extremely difficult to hedge against movements in totally exogenous factors. The sharp rise in the United States dollar against the Japanese yen had undermined the competitiveness of South-East Asian countries, whose currencies had been mostly tied to the dollar. Had the yen appreciated, rather than the dollar, which might well have happened, the situation would have been just the reverse.

23. While some prudent regulation would be welcome, especially in the banking sector, it was important not to cross the thin line between regulation and over-regulation. The international community might seriously consider setting up a contingency facility, managed by the International Monetary Fund, to which countries facing a financial crisis could have access, provided they were eligible according to pre-determined criteria. The mere existence of such a facility would in many cases be enough to discourage speculative shocks. Had such a mechanism existed during the Mexican crisis of 1994, it would not have been necessary to hold urgent negotiations.

24. Private capital flows, another aspect of management, were concentrated in 12 to 20 countries; indeed, 75 per cent of private flows had gone to 12 countries in the past five years. Noting that in the European countries and in the United States of America, Governments offered incentives for investing in backward regions, he suggested that foreign aid that was not channelled into the social sector or infrastructure could perhaps be used to attract substantial private flows to low-income developing countries in Africa, Asia and Latin America that were currently excluded. Such capital subsidies would assure prospective investors that Governments were prepared to bear a portion of the risk.

25. Ms. Djatmiko (Indonesia) asked Mr. Buira whether dealing with currency crises in a more timely fashion would prevent their contagion. She also wondered whether the recently proposed Asian fund initiative could act as a contingency fund to forestall crises.

26. Mr. Buira (Banco Nacional de México) replied that a lender-of-last-resort scheme or an emergency facility might prevent a crisis from occurring. Such facilities were designed to boost the confidence of the markets and the countries concerned. Of course, sound national financial and economic policies would have to be a precondition for receiving international support in a crisis. Support was costly only when it was provided after the fact, when a country's economy had already deteriorated.

27. Mr. Sengupta (Indian Planning Commission) said that he did not yet know the full details of the Asian fund initiative announced only days earlier. It seemed to him, however, that such a fund would not be equipped to act as a contingency facility.

28. Mr. Ojimba (Nigeria) suggested that the major industrialized countries were exploiting opportunities for speculation. He wondered what measures could be taken to protect fragile economies in such cases and whether the monitoring role of the International Monetary Fund (IMF) should be more clearly defined.

29. Mr. Sengupta (Indian Planning Commission) said that certain countries would remain vulnerable until their transition to a market economy had been completed. He did not necessarily believe that speculators were exploitative. Rather, it was the task of the international community to prevent such attacks on fragile economies by implementing sound and appropriate policies.

30. Mr. Cordeiro (Brazil) inquired about the preconditions for orderly capital account liberalization and the time-frame

involved. He wondered whether further liberalization of trade, particularly with respect to the exports of developing countries, such as textiles and agricultural products, would be a prerequisite for the universal liberalization of capital accounts.

31. Mr. Buira (Banco Nacional de México) replied that, while he understood the advantage of freedom of capital movements and capital investment, he had also witnessed the terrible impact that a reversal in capital flows could have. The preconditions for capital account liberalization should include sound public finances and a strong financial system. Nonetheless, sound policies were not in themselves sufficient to ward off speculative attacks. Trade liberalization would strengthen countries' balance-of-payments position and, as a consequence, their current accounts. However, a massive inflow of capital would result in a certain degree of appreciation and a growing current- account deficit, a situation that could make markets nervous. The European countries that were members of the Organization for Economic Cooperation and Development had themselves taken 25 years to liberalize their capital accounts, yet they were now calling on all countries to do so. That was unrealistic.

32. Ms. Lim (University of Michigan) said that macroeconomic policy was indeed a decisive factor. Thailand had long had exploding current account deficits and weak fundamental macroeconomic indicators. It was not clear why the markets had remained there and continued their lending operations. One possible reason was that the Bank of Thailand had not disclosed sufficient information to form a basis for sound judgement. Greed and stupidity had also come into play.

33. Governments had now become minor players in an arena where markets and the private sector were the main actors. For example, in Indonesia, macroeconomic policies had been sound but information about the much larger private sector had been lacking. Regulation of the number of banks established, their staffing and operation had also been inadequate. In general, the regulation and phased liberalization of the private sector were approaches that merited further consideration.

34. Mr. Kebede (Ethiopia) asked what steps small countries such as his own, which had embarked on programmes of structural adjustment and macroeconomic reform, could take to protect themselves from becoming the victims of currency crises.

35. Ms. Lim (University of Michigan) said that small countries should be cognizant of their own capabilities and attempt to invest – if necessary, with foreign aid – in managerial expertise in both the public and private sectors. They should also resist pressure to open up their financial markets to outsiders until they felt capable of managing them.

36. Mr. Ahmed (Associate Administrator of the United Nations Development Programme), Moderator, said that a number of conclusions could be drawn from the panel discussion. First, it was clear that poorly managed markets were not efficient and that the role of the private sector in development was increasing in the 1990s. Moreover, the recent financial crisis in South-East Asia had demonstrated that the impact of unpredictable market forces could extend to an entire region and even beyond.

37. Second, the efficient functioning of financial markets depended mainly on a strong national capacity to manage both those markets and the banking sector. Institution- and capacity-building were necessary to counter a weak financial sector: in the public and semi-public sectors, supervision must be strengthened in order to prevent over-borrowing or lending to specific sectors in times of rapid economic growth. With regard to private-sector banking, better management and a larger capital basis would be essential.

38. Third, a country's vulnerability was more likely to be reduced by investments that fostered broad-based development than by investments in a few capital-based projects and sectors. Recent events had made it clear that an emerging financial sector should not limit its activities to real estate financing and stock market speculation. Domestic and foreign private capital should be distributed more evenly so as to benefit the population as a whole and limit the risks of overheating in one sector.

39. Fourth, official development assistance could facilitate the increase of private capital flows to a greater number of countries. Development cooperation had a crucial role to play in equalizing the distribution of capital flows both among and within countries. Relatively small quantities of public resources could be used to attract private investment. Recent experience had shown that even countries with sound macroeconomic policies were subject to the vagaries of the international capital market. An international system or mechanism, such as a contingency fund, was necessary to absorb, or – better yet – to prevent, such shocks.

Agenda item 97: Sustainable development and international economic cooperation (continued) (A/C.2/52/L.14 and L.15)

(c) Population and development (continued)

Draft resolution on Population and Development (A/C.2/52/L.15)

40. Mr. Kisiri (United Republic of Tanzania), speaking on behalf of the Group of 77 and China, introduced draft resolution A/C.2/52/L.15, which called for the convening of a special session of the General Assembly in 1999 to review and appraise the implementation of the Programme of Action of the International Conference on Population and Development.

(d) International migration and development, including the convening of a United Nations conference on international migration and development (continued)

Draft resolution on international migration and development, including the convening of a United Nations conference on international migration and development (A/C.2/52/L.14)

41. Mr. Kisiri (United Republic of Tanzania), speaking on behalf of the Group of 77 and China, introduced draft resolution A/C.2/52/L.14, drawing particular attention to paragraph 9.

The meeting rose at 5.50 p.m.