

CAPITAL FLOWS FROM SOUTH TO NORTH: A NEW DYNAMIC IN GLOBAL ECONOMIC RELATIONS

SYNOPSIS

This Analytical Note looks at the new dynamic of capital flows from the South to the North arising from unprecedented levels of capital reserve accumulation by the South. It looks at some of the reasons for such capital accumulation – pointing to the perceived need by developing countries to self-insure themselves against financial crises. It then looks at various ways in which financial crises could be prevented by developing countries and concludes by stressing the need for this new dynamic to be reflected in both international economic arrangements and in terms of ensuring that developmental gains by developing countries are obtained.

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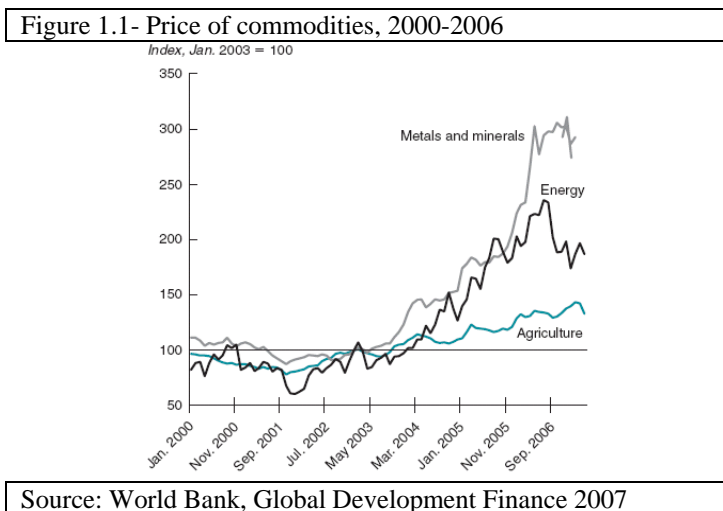
CAPITAL FLOWS FROM SOUTH TO NORTH: A NEW DYNAMIC IN GLOBAL ECONOMIC RELATIONS*

I. The Global Economy and South-North Capital Flows: An Overview

1. Since 2002, the global economy expanded strongly, with low and middle income countries growing at historically high levels (Table 1.1). Commodity prices soared due to buoyant external demand (Figure 1.1), benefiting many commodity exporting economies. Inflation remained low in all the regions, showing an improved economic management (Table 1.2). In addition, interest rates have been low and no financial crises were registered.

	1960-80	1980-90	90-2000	2001	2002	2003	2004	2005	2006
World	4.3	2.9	2.7	1.6	1.8	2.8	4.1	3.5	4.0
High income	4.2	3.0	2.5	1.2	1.4	2.1	3.3	2.7	3.1
Low & middle income	5.1	2.8	3.5	3.2	3.6	5.5	7.3	6.6	7.3
East Asia & Pacific	6.2	7.0	7.5	6.6	7.9	8.8	9.0	8.9	9.5
Latin America & Caribbean	5.2	1.1	2.9	0.3	-0.8	2.0	5.9	4.5	5.6
Europe & Central Asia	n/a	n/a	-0.2	1.9	4.8	5.9	7.2	6.0	6.8
South Asia	3.4	5.0	5.0	4.6	3.7	7.6	7.8	8.7	8.6
Middle East & North Africa	n/a	3.0	3.3	3.4	3.7	3.1	5.9	4.3	5.0
Sub-Saharan Africa	4.2	1.7	2.2	3.5	3.4	4.2	5.1	5.7	5.6

Source: World Bank, World Development Indicators



* This is a revised version of a draft paper whose initial findings were presented at a Panel Event on South-North Capital Flows and the Search for Innovative Sources of Finance, co-organized by the South Centre, CIDSE, and the UN DESA - Financing for Development Office, on 22 October 2007, at the UN Headquarters in New York. For documentation on this panel event, please see http://www.southcentre.org/index.php?option=com_content&task=view&id=472&Itemid=141. The South Centre acknowledges the research contributions of Mr. Manuel Arias to this Analytical Note.

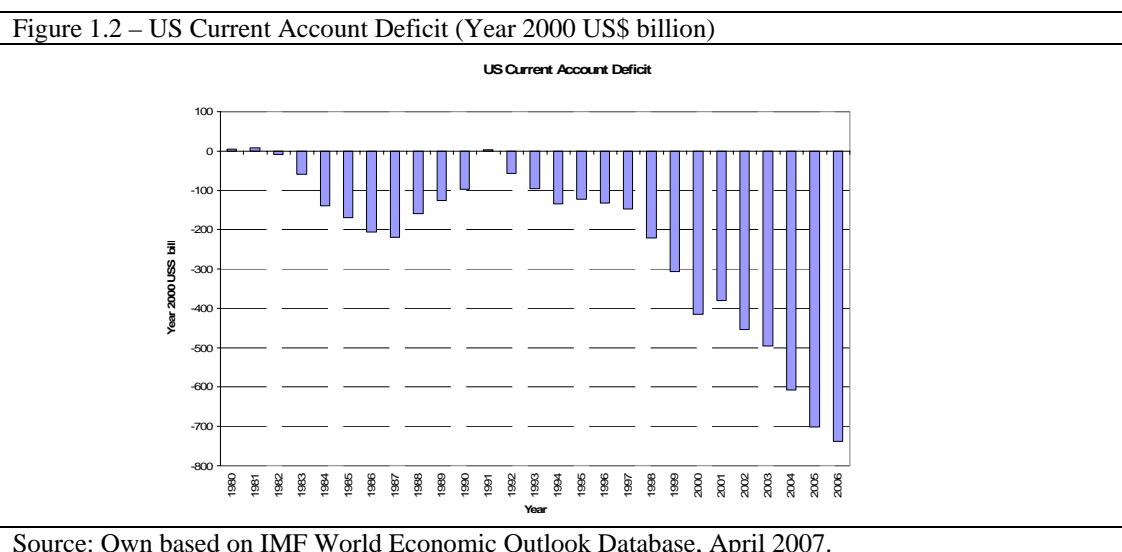
	1980-90	1990-2000	2001	2002	2003	2004	2005	2006
World	14	15	4	3	4	4	4	4
High Income	5	2	2	2	2	2	2	2
Low and Middle Income	28	38	7	6	6	6	5	5
Asia	9	8	3	2	3	4	4	4
Latin America	121	65	6	9	11	7	6	5
CIS and Mongolia	1	182	20	14	12	10	12	10
Central and Eastern Europe	23	47	20	15	8	6	5	5
Middle East	11	10	4	5	6	7	7	8
Africa	15	25	13	10	11	8	8	10

Source: IMF World Economic Outlook Database

2. However, behind this rosy scenario, there is a feeling of uneasiness with the global imbalances that the world economy has harbored. In 2005, the World Economic and Social Survey of the U.N. stated:

“The global economy has large and widening imbalances across regions, reflected in a large current-account deficit in the United States of America, which is matched by an aggregate of surpluses in a number of other countries, mainly in Asia and Europe, and including a group of oil-exporting countries. These imbalances are continuing to widen and policy-makers worldwide are increasingly concerned about their sustainability, about the risks associated with various adjustment processes and, ultimately, about their implications for global financial stability and the growth of the world economy”

3. This diagnosis is even more acute now. The US current-account deficit has continued expanding, reaching historically high levels¹ (Figure 1.2). Running an external deficit means for an economy that it needs foreign funding. Then a salient characteristic of this expansive period is that the US has been borrowing money from the rest of the world at an unprecedented level.



¹ US current external deficit roughly equals Korea’s GDP, and more than 6% of US GDP- by far the largest share in modern times.

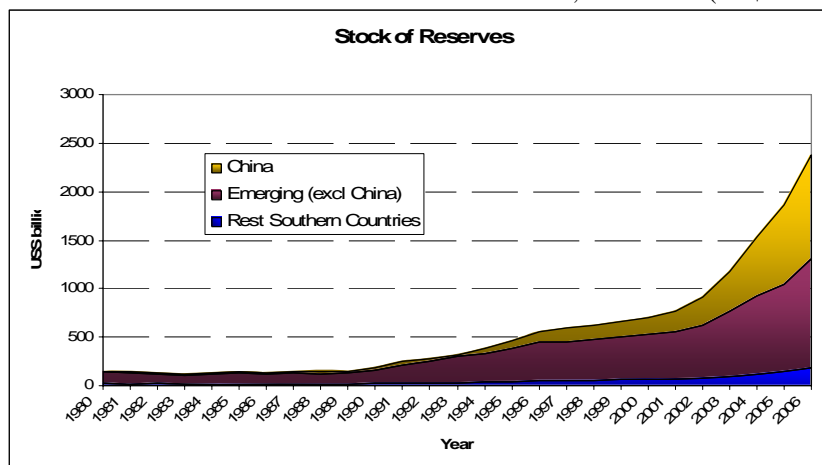
4. Annex I provides a summary of what happened with Southern² countries in recent years:
 - Southern countries have been sending capital to the rest of the world at an increasing pace. Net transfers from Southern countries to the rest of the world increased from US\$ 127 billion in 2002 to US\$ 627 billion in 2007. A major part of these transfers were used to fund the US external deficit, leading to the most paradoxical feature of the last five years: poor and middle income countries lending money to the wealthiest nation in the world at a massive scale.
 - This process took place mainly through the large accumulation of international reserves, especially from Asian and Middle Eastern countries. Africa and Latin America have also been transferring capital abroad via reserve accumulation, though at a much lesser scale than the other Southern economies.
 - Private capital flows to Southern countries increased in the last years, led by direct investment, and while official flows have been negative as middle income countries –especially in Latin America- cancelled their obligations with Official creditors.

II. The Accumulation of International Reserves

5. The most outstanding feature of the international economic system in recent years has been the large accumulation of international reserves by Southern countries. Reserves stock increased from US\$ 780 billion in 2001 to US\$ 2.4 trillion in 2006, being the main mechanism through which the transfer of capital from Southern countries to the rest of the world took place. The steep increase in international reserves registered since 2001, was a process clearly led by China, but followed by many southern countries (Figure 1.3).

² For the purposes of this paper, the phrase “Southern countries” refer to developing countries – e.g. countries which are not economies in transition or members of the Organization for Economic Cooperation and Development (OECD).

Figure 1.3 – International Reserves of Southern Countries, 1980-2006 (US\$ billion)



Source: IMF, International Financial Statistics

6. What is surprising about this phenomenon is that Southern countries are accumulating more reserves than normally needed. Two indicators are used for calculating the “normal” level of reserves required:

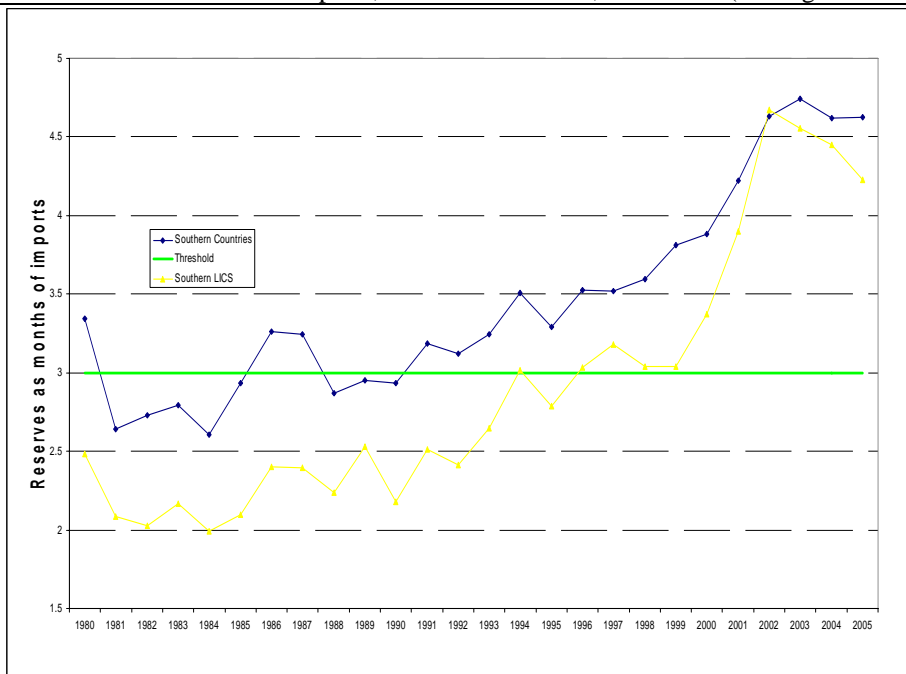
- (1) **Months of imports covered by reserves.** In the past, conventional wisdom stated that reserves should cover at least 3 months of imports. The rationale was that countries should have enough reserves to avoid import bottlenecks in the event of an adverse external shock in their trade balance. Yet this indicator is not very relevant today for financially integrated economies: as Wyplosz (2007) explains, “the prevalence of the trade balance as the main source of unexpected disturbances may be an acceptable assumption for low-income developing countries that are characterized by export specialization in a narrow range of staple goods”.
- (2) **Reserves-to-short term debt ratio:** For countries that are financially integrated, the most important source of uncertainty is the capital account. Therefore, in the late 90s the three-months-import-coverage rule was replaced by the Guidotti-Greenspan rule, which states that reserves should equal short-term external debt (one-year or less maturity)³, implying a ratio of reserves-to-short term debt of 1. The rationale is that countries should have enough reserves to resist a massive withdrawal of short term foreign capital.

7. Figures 1.4, 1.5 and 1.6 depict the recent evolution of both indicators. Two conclusions emerge: first, southern reserves are, on average, above the

³ The rule is named after Pablo Guidotti – Argentine former deputy minister of finance – and Alan Greenspan –former chairman of the Federal Reserve Board of the United States. Guidotti first stated the rule in a G-33 seminar in 1999, while Greenspan widely publicized it in a speech at the World Bank (Greenspan, 1999). Guzman Calafell and Padilla del Bosque (2002) found that the ratio of reserves to external debt is a relevant predictor of an external crisis.

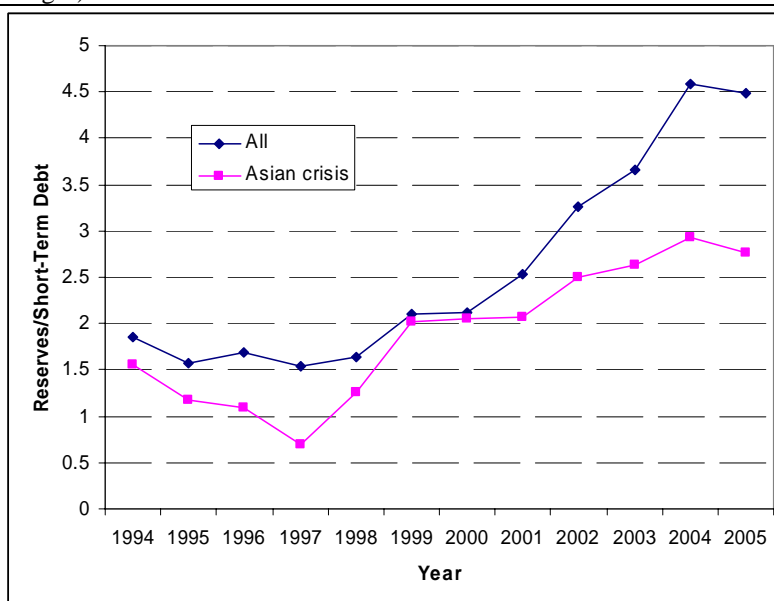
“normal” thresholds; second, both indicators show an increasing trend after 1999/2000.

Figure 1.4 – Reserves as months of imports, Southern Countries, 1980-2005 (unweighted averages)



Source: World Bank, World Development Indicators

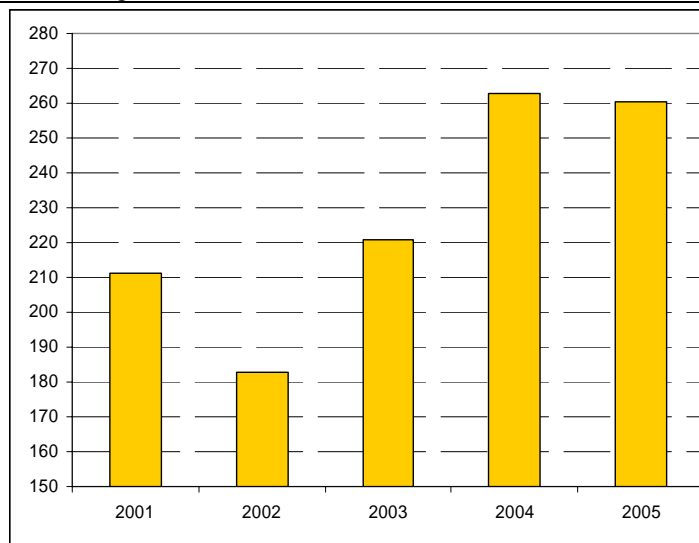
Figure 1.5 – Reserves as short-term foreign liabilities, Selected Southern Countries*, 1994-2005 (unweighted averages)



Source: Joint BIS-IMF-OECD-WB Statistics on External Debt

* Selected Countries are Southern countries labeled as emerging markets: Argentina, Brazil, Chile, China, Colombia, Egypt, India, Indonesia, Jordan, Malaysia, Morocco, Pakistan, Peru Philippines, South Africa, Thailand and Venezuela.

Figure 1.6 – Short-term foreign liabilities, Selected Southern Countries, 2001-2005 (US\$ billions)



Source: Joint BIS-IMF-OECD-WB Statistics on External Debt

8. Why is this excess reserve accumulation occurring? There are two hypotheses: the first is the “mercantilist” interpretation. It states that Southern countries are hoarding reserves as a mean to support export-led growth by keeping undervalued exchange rates⁴. Recent empirical studies have reaffirmed the rationale for such a policy, showing that undervalued real exchange rates have positive effects on economic growth⁵. There is also a “precautionary” interpretation: Southern countries are using their reserves as a mean of self-insurance⁶ against crises. Financially integrated countries usually have significant short-term external debt (“hot money”), counting on continued inflows of external capital to service such debt. If for some reason countries do not receive any more inflows (sudden stop) or register sudden outflows (sudden flight) then it is very likely that a crisis will occur. Having large reserves decreases the likelihood of a crisis, as countries are less dependent on external flows to honor their external liabilities. There is a second precautionary reason for holding reserves, related to the underdevelopment of the banking system in some emerging markets. In those cases, given the inability of domestic financial markets to channel (domestic) savings into (domestic) investments, and the potentially high exposure to domestic nonperforming loans, monetary authorities might desire to direct “excess” savings abroad via reserve accumulation.

⁴ See Dooley et al. (2003) for a more detailed exposition of the mercantilist interpretation.

⁵ See Rodrik (2007); Hausmann, Pritchett and Rodrik (2005); Razin and Collins (1999).

⁶ Technically speaking, it is not accurate to say that countries are insuring themselves, because insurance entails the payment of some compensation when the insured risks occur, but reserves only mean lower probability of a crisis, not a payment in case of crisis. Still, in the discUS\$ion about reserves accumulation the term “self-insurance” is well accepted and thus will be used in this paper. See Wyplosz (2007) for further discUS\$ion.

9. Both explanations have been empirically tested using different approaches⁷. The results of these studies are that the precautionary motivation prevails, but in certain Asian countries –especially China– “mercantilist” motivations also play a role. Still, these studies have omitted domestic financial issues when assessing the precautionary motivation. It is likely that if these factors are also taken into account, the precautionary motivation would be given more weight.
10. To better understand why countries want to have self-insurance, it is important to realize that the expansion in international reserves began in the aftermath of the Asian crisis. This is not surprising, as the crisis taught Asian countries that having solid economic fundamentals did not exempt a country from experiencing a painful outflow of capital, and that the International Financial Institutions are not a reliable source of insurance, since they impose harsh conditions and the capital they disburse are of little help against a speculative attack. Having this in mind, financially integrated economies reassessed the risks faced, increasing their risk aversion. In addition, short-term capital flows to Southern countries have been expanding since 2001 (Figure 1.6), augmenting the risks faced. Figures 1.5 and 1.6 suggest that Southern countries have increased their reserves because they face higher risks and are more risk averse than in the past.
11. Which are the costs of accumulating reserves as Southern countries have done in recent years? Broadly, two types of costs can be identified: those that arise from how reserves are being invested, and those, more fundamental, that are related to hoarding excess reserves. Within the last group, two costs are outlined: first, the opportunity cost of reserves; second, the domestic implications of its accumulation.
12. Reserves are currently being invested mainly in US dollar-denominated assets, especially low-yielding Treasury bonds, deposits and Agency securities⁸ -which are among the most liquid financial assets. It is reasonable to follow this strategy when reserves are at “normal” levels because reserves need to be readily available, but when reserves are excessive critics⁹ argue that more aggressive reserve management strategies should be pursued, as the yields can be substantially higher. It has also been argued¹⁰ that the US dollar assets do not compensate foreign investors fully for the risk of future dollar depreciation, implying that the currency composition of Foreign Reserves by Southern countries should be more diversified. Indeed, Southern

⁷ See Aizenman and Lee (2006), Jeanne and Ranciere (2006) and Wyplosz (2007), The first study assesses econometrically which are the main factors behind the reserve accumulation and concludes that those connected with the precautionary motive are stronger. The second study develops a model that estimate an appropriate level of reserves for precautionary motivation, and finds that most of the countries indeed behave in accordance to it. The last paper argues that a “mercantilist” strategy is not sustainable, and that reserve accumulation are a reflection of growing risks for Southern countries.

⁸ Agency securities are issued by US Government Corporations or Sponsored Enterprises. Technically they are not Treasury securities, but many of them are guaranteed by the US government.

⁹ See Summers (2006).

¹⁰ Roubini and Setser (2005)

countries have embarked in more complex investment strategies in recent times. On one hand, the currency composition of reserves has diversified¹¹: while in 1997 US dollar denominated assets represented 72% of reserves in developing countries that report their reserve composition to the IMF¹², in 2007 the figure was 59%. Still, it is likely that China is not included in the IMF reports, and it is estimated¹³ to hold 70/75% of its reserves in US dollars. On the other hand, Central banks are investing in more complex financial instruments –such as interest rate derivatives- and even equities.

13. The emergence of Sovereign Wealth Funds¹⁴ in many developing economies has provoked a strong debate in the media¹⁵ over the possibility that Southern countries might control substantial stakes in American and European companies. Ironically, Larry Summers –who advocates for more aggressive reserve management by Southern countries-, claims that Sovereign Funds should be highly regulated and that they “shake the logic of capitalism”. Finally, Southern countries have also used their reserves to repay debt with official creditors, refinance their external debt in more favorable financial conditions, and capitalize public owned enterprises.
14. A second group of studies focus on the costs of accumulating reserves for precautionary motives. Rodrik (2006) estimates this cost as the difference between the interests paid on short-term external debt and the yields on the reserves that are accumulated to prevent the risks derived from that external debt. For a five percentage points difference, the cost equals one percent of developing countries’ GDP –more than total Official Development Assistance funds. Baker and Walentin (2001) argue that countries should promote higher domestic investment rather than accumulate reserves. They estimate the cost of hoarding reserves as the difference between returns on domestic investments and returns on reserves, finding that additional reserves imposes a cost of two percent of developing countries’ GDP –and this estimate might be higher with the current level of reserves accumulation.
15. Hoarding reserves might also have implications for fiscal and monetary policies. A Central Bank issues domestic currency for purchasing foreign exchange reserves. If demand for domestic currency remains constant, the additional domestic currency can increase inflation. To prevent it, Central Banks sterilize their interventions in Foreign Exchange markets by issuing

¹¹ See Wooldridge (2006) for further details about currency diversification strategies.

¹² IMF presents this information in the Currency Composition of Official Foreign Exchange Reserves (COFER) database, in which countries report anonymously their reserve composition; only aggregated data –for total, industrialized and developing economies- is published. 80/ 90 developing countries (out of 160) report their currency composition. They represent between 51 and 66 percent of total developing country reserves

¹³ Setser (2007b)

¹⁴ Sovereign Wealth Funds (SWFs) are investment funds owned by states. They invest mainly in foreign companies. Originally they were used by oil producer countries to channel oil windfalls, but they have popularized and nowadays industrial countries such as China, Korea and Singapur have their own SWF.

¹⁵ See Summers (2007), Setser (2007a), The Economist (2007), Roubini (2007).

domestic bonds, which absorb the domestic currency issued. Recent studies¹⁶ have identified the following potential costs embedded in reserve accumulation and domestic currency sterilization:

- (1) Fiscal cost: The interest rate that the Central Bank has to pay on its bonds is higher than the yields on the reserves, thus carrying a loss. The extent of the loss determine the sustainability of the sterilization policy: above a threshold, sterilization is no longer sustainable¹⁷. However, interest rates have been unusually low in recent years. Moreover, Levy-Yeyati (2006) argues that as countries increase their reserves, they reduce their country-risk –implying lower interest rates on government backed bonds. Therefore, although interest rate differentials might entail substantial losses and compromise the sustainability of sterilization for a country accumulating reserves, in recent years these have not occurred.
 - (2) Monetary imbalances: Central Bank debt is usually short-termed and bought by domestic banks. If financial institutions feel better placed to expand credit having these liquid assets, they might indirectly create monetary expansion and thus undermine the sterilizing effects of bonds. There is no evidence that this phenomenon actually took place.
 - (3) Financial Sector imbalances: If there are expectations of a future currency appreciation, this may attract large short-term capital flows, which may overheat credit and asset markets and pave the way for a future financial crisis. Indeed, many developing markets have experienced booms in private credit, equity and housing prices.
 - (4) Inefficiencies in the financial sector: Central Banks might be tempted to resort on non-market instruments –such as increasing reserve requirements for commercial banks- for draining excess liquidity, implicitly taxing the banking system. It has also been argued that Central Bank bonds might crowd out private bonds, but this theoretical argument has not been backed by evidence in recent times.
16. Of course, the strategy of reserve accumulation has its benefits for Southern Countries. The most obvious advantage of having additional reserves is that they contribute to prevent currency crisis, which are very costly in terms of output –estimates range from 8% to 25% of the GDP¹⁸. Lower external vulnerabilities also mean lower debt costs, as mentioned above. Another, more subtle, beneficiary of the reserve accumulation of Southern countries has been the United States. The strong demand for US dollar denominated debt meant that the United States were able to finance increasing external deficits at a relatively low cost. The availability of cheap credit contributed to

¹⁶ Mohanty and Turner (2006), and International Relations Committee Task Force (2006).

¹⁷ See Frenkel (2007).

¹⁸ Hutchison and Noy (2005)

sustain the boom in US asset markets, such as housing¹⁹. External imbalances are then inextricably related to the accumulation of reserves.

17. When analyzing the suitability of the reserves accumulation strategy both the benefits and the costs must be gauged. As many Southern countries are following it, it seems clear for them that the benefits of avoiding crises outstrip the costs of accumulating reserves. Still, this is a suboptimal strategy: a centralized and cooperative arrangement, which would hedge crisis risk of Southern countries, would not only attain lower external vulnerability for them at a lower cost, but also contribute to reduce global imbalances. What is needed is a credible global or regional lender of last resort that could provide the appropriate insurance.
18. In short, Southern countries are transferring funds to the rest of the world (mainly the US) via reserves accumulation. Their main motivation is to be protected against the external risks they face in a financially liberalized world. The hoarding of reserves implies that the richest nation in the world can easily borrow funds at a low cost from Southern Central Banks, sustaining (and deepening) global imbalances.
19. The message is that managing vulnerability in a financially integrated world is a key issue to address global imbalances and understand the recent pattern of reserves policy by Southern countries. As will be argued later in this paper, there are alternative and cheaper strategies for reducing vulnerability. For this discussion, the topics of crisis prevention and global economic governance must be brought into the debate.

III. Private and Official Capital Flows to Developing Countries

20. Southern countries have received high and growing private capital flows, led by a surge in Foreign Direct Investment. The expansion in FDI is explained both by domestic and international factors: strong growth in Southern economies, low interest rates that provide cheap funding, and high commodity prices.
21. Although Southern countries still receive a relatively minor fraction of World FDI (25%²⁰), the share is increasing. Within Southern countries, FDI is highly concentrated, with Asian countries receiving more than 60% of gross FDI. A recent development, pointed out in 2006 World Investment Report, is that Southern countries are becoming source of FDI, mainly to other southern partners. This phenomenon, moderate in global scale²¹, tends to be relevant for receptor countries.

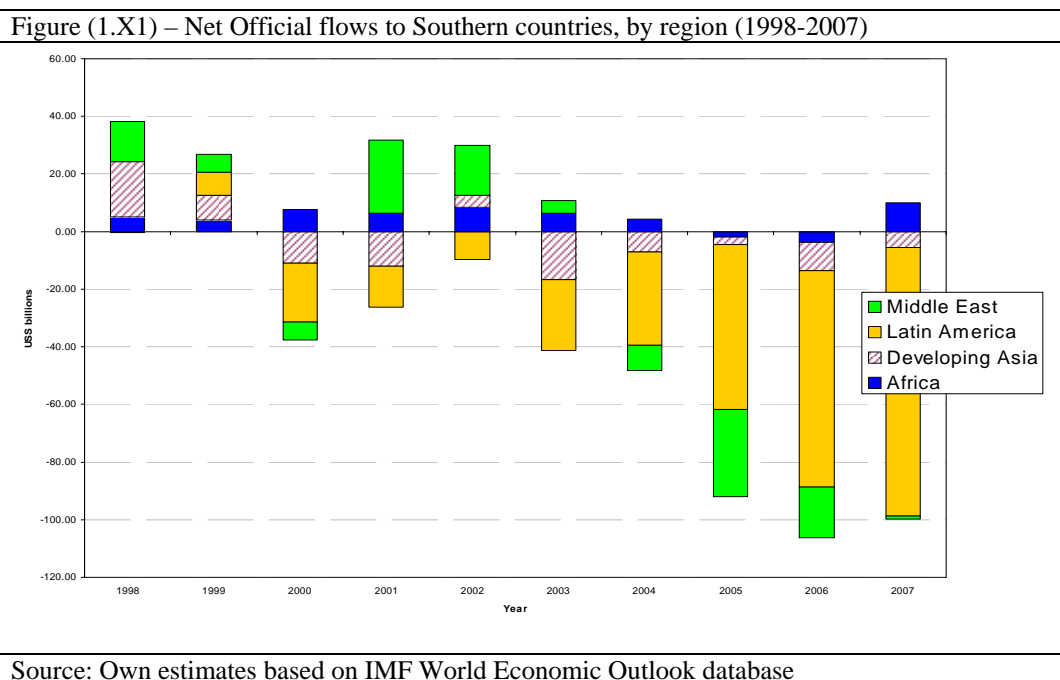
¹⁹ See Cassidy (2007) and Setser (2007c).

²⁰ Source: Own calculations based on UNCTAD FDI database.

²¹ Southern countries still represent less than 15% of FDI outflows.

22. Regarding the composition of FDI to Southern economies, Africa is attracting investments into natural resources, prompted by high commodity prices. Oil producing countries –Algeria, Chad, Egypt, Equatorial Guinea, Nigeria and Sudan- has been receiving increasing FDI, reaching 48% of inflows into the region in 2005 (World Investment Report, 2006). Developing Asia, led by China, has been consistently receiving strong flows in the manufacturing sector. Middle Eastern economies attracted flows into services (telecommunications, financial services and tourism) and oil industry. In Latin America, most of the FDI inflows were for Merger & Acquisitions in the manufacturing sector, and to oil producing countries.
23. Private portfolio flows –which include portfolio and equity investment- behaved relatively balanced during the last years, and no clear trend appears. The negative figures of 2006 are explained by the unsteadiness that characterized emerging markets in May-June 2006 –after substantial equity price increases in 2005- and debt-buybacks of bonds by Southern countries.
24. Private capital markets have witnessed new trends in recent years. First, local currency bond markets have emerged in some countries. The benefit of developing these markets is that they reduce a country’s exposure to debt currency mismatches, thus mitigating the balance sheet effects of a potential currency crisis. Another development in recent years is the “carry trade” boom²². It consists in a simple financial operation: borrowing funds in a low-yielding currency and selling it for buying and lending in a high-yield currency. In a world of quasi-fixed exchange rates, with sophisticated capital markets that allow highly leveraged operations and relatively large interest rate differentials between the borrowing and lending country, “carry trade” has become increasingly popular and profitable.
25. Official lending (ie, non-concessional loans provided by the World Bank, IMF, Paris Club, and regional banks), on the other hand, has been negative since 2003, due to repayments by Southern borrowers. Most of the large repayments were done by middle-income economies, notably from Latin America, as shown in Figure 1.X1.

²² See UNCTAD (2007) for further details, from where most of the explanations and facts that follows were taken.



26. Repayments to the IMF play an important role in this process (Table 1.X1): Brazil cancelled US\$ 17.8 billion of its obligations in 2005; Argentina also prepaid US\$ 9.6 billion in 2006. The World Bank (2007) considers this fact in a positive way, as a reflection of international financial stability. However, this interpretation omits the tense negotiations that surrounded refinancing debt with the IMF in previous years for these countries. A more balanced and accurate view is that Southern countries are taking advantage of the good financial environment and their solid positions to free themselves from the conditionalities and political costs that are embedded in IMF lending. Now the main borrowers of IMF non-concessional loans are small economies (Table 1.X2).

Table 1.X1 - Largest repayments by Southern countries to official creditors, 2005/6

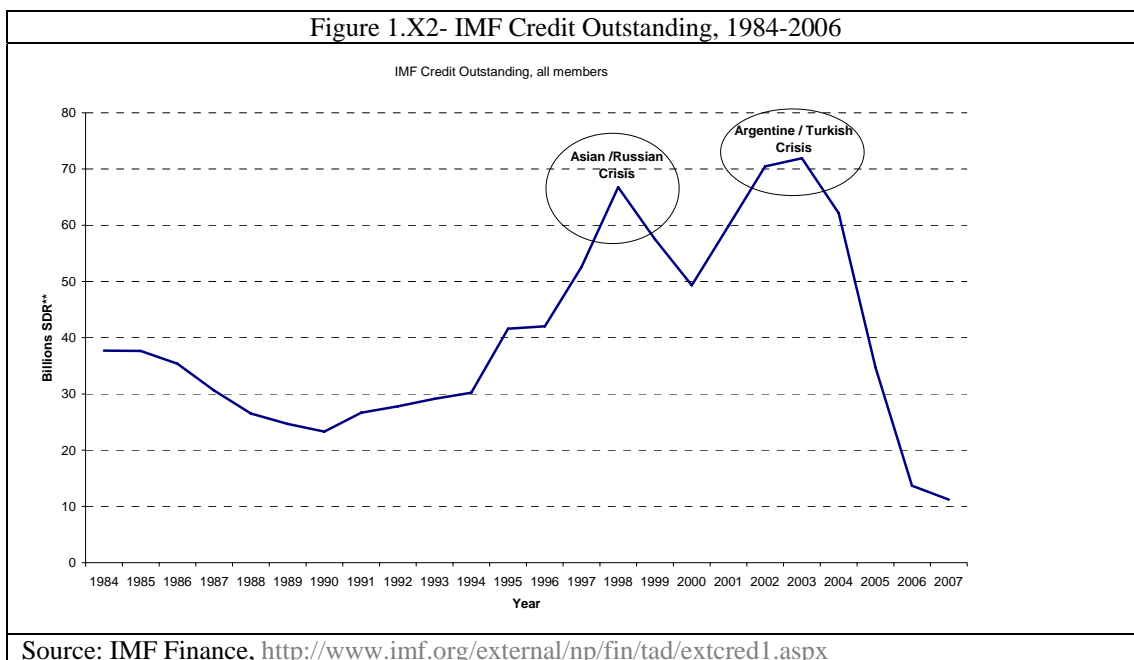
	Repayment in 2005/06 (US\$ billions)	Official Creditor
Brazil	16.8	IMF
Argentina	12.0	IMF
Indonesia	9.0	IMF
Algeria	8.0	Paris Club
Nigeria	7.5	Paris/London club
Uruguay	2.5	IMF
Brazil	2.0	Paris Club
Peru	2.0	Paris club

Source: Own based on World Bank (2007)

	2000		2006
Brazil	6.09	Uruguay	0.30
Indonesia	1.38	Dominican Republic	0.22
Pakistan	0.61	Sri Lanka	0.15
Philippines	0.35	Bangladesh	0.10
Algeria	0.31	Kenya	0.07

Source: World Bank, Global Development Finance 2007

27. Due to these repayments and the absence of international crisis, the IMF has sharply decreased its credit outstanding, reaching a historically low level (Figure 1.X2) and facing comments over its growing irrelevance in the global financial stage²³. Moreover, its financial situation worsened dramatically, as IMF activities are financed mainly from the proceeds of its credits²⁴.



IV. Financial Crisis and Crisis Prevention

28. The large transfer of capital from South to North, taking place through reserve accumulation, can be mainly explained by the desire of Southern countries to avoid suffering balance of payment crisis. Thus, despite the recent absence of major balance of payment disruptions in Southern

²³ See Economist (2006), Sánchez (2007), Kapur and Webb (2006)

²⁴ For this reason, the Managing Director established the “Committee of Eminent Persons to Study Sustainable Long-term Financing of IMF Running Costs” on 18 May 2006, which published a report on IMF long term financing on January 31st 2007.

economies, the issue of crisis and crisis prevention – i.e. mitigating vulnerability to external financial shocks – remains pressing.

29. The literature on external vulnerability is extensive. The recurrence and high cost of crises during the 1990s motivated several discussions on mitigating external vulnerability. The literature can be divided in two groups: first, “general approaches” to mitigate vulnerability have been developed; these are aimed at identifying signs of vulnerability in an economy and trigger responses –either from the market or policy makers- that stabilize an economy. Second, there has been discussion over specific policies and initiatives that can be put in practice to reduce vulnerability. There are different policy spaces for these policies: domestic, regional and global.
30. Two general approaches have been proposed to reduce external vulnerability:
 - (1) Early Warning Systems (EWS): Goldstein et al. (2000) –building on an extensive previous literature²⁵- studied financial crises with the purpose of identifying empirical regularities and key indicators of crises. These would enable public officials and the market to recognize vulnerability ex-ante (whenever an indicator deviates from “normal” levels, defined by thresholds) and adopt the corrective policies that would prevent crises from happening. The strongest critique to this approach is that financial crises are always unpredictable. The models based on the lessons from the last crisis often fail to prevent the next one. Other critiques are that EWS require information not always timely available in developing economies, that the interpretation of indicators should be endogenous to the economic environment rather than “scientific”, and that markets can react to information in a destabilizing way – precipitating the crisis that EWS are intended to avoid.
 - (2) Trip Wires and Speed Bumps: Grabel (2004) strongly criticized EWS and presented her alternative approach. It consists on “trip wires” – indicators, selected by each country officials based on the risks and particularities faced by their economy- which serve as a diagnostic tool for assessing vulnerability and might trigger “speed bumps” – regulatory actions that alter investor behavior in ways that avert crisis- in case of difficulties. Grabel argues that her approach has three crucial differences with the EWS. First, in her view, the EWS approach place much emphasis on the stabilizing effects on markets that the information provided by the indicators might have. She differentiate herself by acknowledging that trip wires have narrow value as a diagnostic tool, and are not expected to stabilize markets *per se*, but with the combination with speed bumps. Second, the trip-wires-speed-bumps approach believes that specific, targeted changes in policy and behavior by regulators are required to curtail financial risks. Third, she argues that the informational problems are less stringent in her

²⁵ Kaminsky (1998); Kaminsky et al. (1998); Kaminsky and Reinhart (1998, 1999)

approach, because regulators and policy makers usually have first-hand information on the different trip wires.

31. As this description shows, the logic of both approaches are similar, they differ on the weights they assign to different part of the process. The process consists in having information that signals vulnerability (either the indicators of the EWS or the "trip wires") and using the information to curtail financial risks (either by market movements that lead to stabilization or by specific actions by regulators). The EWS places more importance on having information, the trip-wires-speed-bumps depend crucially on policymakers actions based on the information.
32. As a balance, both approaches can be reconciled. The EWS literature is far larger, providing an exhaustive quantitative analysis based on solid economic theory for selecting the indicators, while the trip-wires-speed-bumps highlights the importance of policy measures to curtail financial risks.
33. There are several specific policies, either in the domestic, regional or international domain, that countries can attempt to mitigate their exposure to financial crises.

A. Domestic Policies to Reduce Capital Flow Vulnerability

34. As we have seen, having bad fundamentals is a cause for external crises. Keeping them right is a necessary -but not sufficient- condition for mitigating external vulnerability. Avoiding real exchange rate overvaluation, and keeping the current account and fiscal balances at a sustainable level are key policy objectives that developing countries' policymakers should pursue to strengthen their economic prospects.
35. Having a large mattress of reserves significantly reduces the risk that sudden stops pose to an economy -since countries have enough liquidity to avoid shortcomings- and sends a powerful signal to markets on the ability of a country to sustain its exchange rate, moderating expectations of abrupt changes. The disadvantage is that accumulating reserves carries large opportunity costs, since reserves are usually invested in low yielding assets while they could finance other projects, and it might create difficulties in the domestic economy. As has been discussed earlier in this paper, despite its problems this is the policy that Southern countries have followed in the last years.
36. Countries can also point out to more systemic features of their external vulnerability, by reducing their exposure to short term capital flows via capital controls. The process of financial globalization -characterized by the total opening of capital accounts in several countries- which started in the 1970's and intensified in the 1990's, is inextricably related to financial crises. The fact that capital flows can move fast and freely implies several risks for

emerging economies: on one side, it facilitates the inflow and outflow of “hot money” - short term capital that flows across borders into different markets in search of higher returns and can be easily reversed²⁶, creating boom-and-bust cycles in domestic markets with disruptive effects to the economy. On the other side, it limits the power of monetary authorities, who lose their power over the monetary policy or the exchange rate²⁷. Therefore, the opening of the capital account diminishes policymakers’ ability to control key variables of an economy.

37. Capital controls can be divided into several categories, depending on their characteristics: price-capital controls (ie, via taxes on capital, reserve requirements²⁸, etc) or quantity-based controls (limits on the amount of capital, license requirements or bans on certain investments); targeting capital inflows or/and outflows, and can be static (not modified despite changes in circumstances) or dynamic (adjusting to the environment).
38. With such a degree of variety, a detailed analysis of capital controls exceeds the scope of this paper. Yet, a superficial analysis of several experiences²⁹ with capital controls point out to the following benefits and costs: regarding the benefits, countries with capital controls have been able to prevent contagion from crises, manage their exchange rate, and alter the composition and maturity of inflows, prioritizing long term inflows. On the side of the costs, capital controls hinder the development of the financial sector, leading to distortions in the allocation of capital and higher capital costs for domestic companies³⁰, and pave the way for corruption, as evading controls is a profitable industry. Naturally, not all experiences were similar: in some cases, such as Chile in the 90s and Malaysia after 1998, capital controls were a very successful tool. In other cases, such as Colombia, the balance was less favorable. Although the literature is far from reaching a consensus, it seems

²⁶ Definition taken from Rajan et al.(2007)

²⁷ This phenomenon is called “the impossible trinity”, which states that countries cannot have simultaneously an open capital account, fixed/quasi fixed exchange rate and autonomous monetary policy. If a country opens its capital account, it loses power over its interest rate –ie, if interest rates are lower than what world markets think interest rate should be, then there will be massive capital outflows; if it is higher, then there will be massive capital inflows; both kind of movements should set domestic interest rate equal to its “correct” level, namely world interest rate plus country risk premium. If a country further chooses to have fixed exchange rate, it will lose control over its monetary policy: any change in the quantity of domestic money that rises (lowers) domestic exchange rate from its “correct” level will be responded by investors who buy (sell) domestic currency at a fixed price, thus increasing (reducing) the quantity of money in the economy. If, on the contrary, a country prioritizes to control the quantity of money in an economy, any change in the quantity of domestic money that rises (lowers) domestic exchange rate from its “correct” level will be responded by investors who buy (sell) domestic currency, thus altering the exchange rate. The bottom line is that, when a country opens its capital account, it must give up control either over the quantity of money or over the exchange rate. This happens because the action of world investors keeps the interest rate at the “correct” level. A country that controls its capital account can avoid this “corrective” action, being able to manage both its exchange rate and its monetary policy.

²⁸ Reserve requirements means that investors must deposit a reserve fund -equal to a fraction of their investment- in a non-interest yielding account for a certain period of time.

²⁹ Based on the work of Epstein et al. (2003).

³⁰ See Forbes (2007a, 2007b).

that capital controls work better when they are consistent with the economic policy.

39. There are two factors that might undermine the effectiveness of capital controls. First, it has been argued that as time goes by, controls become increasingly costly because the distortions they induce exacerbate. However, there is no systematic evidence of this phenomenon. Second, there are practical concerns on the enforcement of capital controls: as financial markets deepen and new, more complex instruments appear, it becomes increasingly difficult for regulators to prevent loopholes in the legislation. This is especially serious because loopholes render controls ineffective. Thus, a country that implements capital controls should have the appropriate technical capacity and political will to prevent loopholes and correct them if discovered.
40. Last, capital controls should be complemented by prudential regulation and supervision of the domestic banking system. As argued before, weakly regulated domestic financial systems can cause and amplify currency crises. Prudential regulations can mitigate the boom-and-bust cycles that typically precede financial crises³¹.
41. In sum, capital controls are a legitimate instrument for mitigating external vulnerability –and indeed have been endorsed by prominent economists³². Still, there is no “capital controls blueprint”. Each country must assess its own vulnerabilities, the maturity composition of the flows it receives, the state of their financial system and their administrative capacity to enforce controls. What needs to be understood is that financial globalization is not an irreversible process, it is a choice. True, as financial instruments become more complex and trade intensifies, it will be more difficult to regulate capital flows. However, more difficult is not impossible. The aim of controls is not to completely insulate a country from capital flows, but to moderate them. And this objective is still feasible for emerging economies.
42. Caballero (2003) highlights the importance of developing financial instruments of hedging and insurance against capital flow reversals in developing countries. Specifically, those instruments would serve for those cases in which countries receive external shocks that might be disruptive for the economy.
43. Last, the likelihood of a crisis can be reduced by issuing domestic currency denominated debt, as some developing countries have been doing in recent years, taking advantage of the favorable financial environment. The advantage of these instruments is that they prevent currency mismatches; the disadvantage is that interest rates paid on this debt is higher than taking debts in “hard currencies”, such as US dollar, Euro or yen.

³¹ See Ocampo (2003) for a complete exposition of the complementary role of prudential regulation and capital account controls as counter-cyclical policy tools.

³² See Bhagwati (1998), Rodrik (2006, 1999) and Stiglitz et al. (2006).

B. Regional initiatives to curtail financial risks³³

44. Regional financial cooperation among developing countries takes place for different purposes. First, exchange-rate and monetary coordination agreements typically have the objective of facilitating trade. Second, regional development banks serve mainly for financing development projects, such as infrastructure. Third, regional monetary funds, reserve pooling and swap agreements are aimed specifically at curtailing financial risks, by providing short- and medium-term financing in hard times. With the advent of contagious regional crises in developing countries, these type of agreements regained momentum.
45. Currently three regional initiatives with the specific purpose of preventing crises exist. First, the Arab Monetary Fund – founded in 1976 and composed by 22 Middle-Eastern and African members³⁴- acts as a regional lender of last resort, providing several financing facilities to member countries based on their specific needs³⁵. The outstanding loans at the end of 2005 amounted to US\$ 1.1 billion, held mainly by Egypt and Sudan³⁶.
46. Second, the Latin American Reserve Fund (LARF) is a reserve pooling agreement, dating from 1978³⁷. Member countries have access to Balance-of-payment and debt rescheduling support credits (for up to 4 years), liquidity and contingent credits (short-term loans, up to one year, to satisfy extraordinary reserve needs and/or resist speculative attacks), and treasury loans (to finance emergency needs, for up to one month). Beyond these activities, the LARF also provides technical support for reserve management to its members, and issues medium-term notes at low spreads³⁸.

³³ This section relies heavily on UNCTAD (2007) and the articles appearing in Ocampo (2006)

³⁴ Egypt, Syria, Iraq, Lebanon, Jordan, Saudi Arabia, Yemen, Algeria, Bahrain, Djibouti, Kuwait, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Somalia, Sudan, Tunisia, the PLO, and the United Arab Emirates.

³⁵ UNCTAD (2007, p. 122) reports the following instruments: “ordinary” and “automatic” loans for countries with Balance of Payments temporary difficulties; “extended loans” for cases in which balance of payment problems are structural and thus require longer repayment terms; “compensatory loans” to face sudden declines in the terms of trade; and finally, a “structural adjustment facility” to support reforms in domestic financial systems and in government finance.

³⁶ See Arab Monetary Fund (2007)

³⁷ At that time it was called the Andean Reserve Fund, because it was formed by Andean Group countries –Bolivia, Ecuador, Colombia, Perú and Venezuela. It changed its name for LARF in 1988, when it decided to admit other non-Andean group countries. Costa Rica has been the only to join it, in 2000.

³⁸ LARF has the highest Latin American credit ratings (Aa2 by Moody’s and AA- by S&P). In 2003 it issued a US\$ 150 billion note, with a three-years maturity, paying 115 basic points above a comparable US Treasury bond. In 2006, it issued a US\$ 250 billion note, with a five-years maturity, paying 20 basic points above LIBOR rate. (Source: www.flar.net)

47. Finally, the Chiang Mai initiative, launched in 2000 by the ASEAN+3 group³⁹ as a reaction to the 1997 Asian Crisis, is the most recent (and popular) regional arrangement projected specifically to prevent external disruptions. It consists of two types of swap arrangements between member countries: The network of bilateral swap agreements, and the expanded ASEAN swap system. A bilateral swap agreement allows the participants to swap their domestic currency against “hard currencies” (dollar, Euro, Yen and, to a lesser extent, renminbi). There is a cap on the amount that can be swapped. If a country draws up to 20% of the maximum, the disbursement is automatic; if not, the country is placed under an IMF structural adjustment program⁴⁰. Bilateral swaps can be one-way or two-way⁴¹. UNCTAD (2007) estimates that the network of bilateral swap arrangements amounts to US\$ 75 billion. The expanded ASEAN system entitles participants to swap their currencies against “hard currencies”, up to a maximum of twice their commitment under the expanded ASEAN agreement. The total funds committed to this system by member countries are US\$ 2 billion.
48. Have these initiatives prevented crises and mitigated external vulnerability? The Chiang Mai initiative is recent, and its implementation has coincided with an expansive cycle of the world economy. It is impossible to assess its role during a crisis, simply because there has not been any in recent years. Regarding LARF, it made valuable contributions at mitigating the effects of the debt crisis that struck its members in the eighties. Indeed, in the crucial years between 1982 and 1984, it provided more exceptional financing than the IMF⁴². While these financing was not sufficient to avoid the crisis, it certainly mitigated its effects. Moreover, in some individual crises, LARF funds were they only external resource available –for example, during Perú hyperinflation in 1988.
49. Regional initiatives to curtail financial risks give a number of benefits to member countries: they reduce the need for costly “self insurance” via reserve accumulation, as they diversify the risk of crises among member countries; they can lead to better reserve management –particularly in the case of reserve pooling agreements- and can receive cheaper funding than individual countries in the international capital markets. Another positive feature of regional agreements, compared to IMF emergency lending, is that country members have more ownership over fund utilization, as the conditionality embedded in the financial aid is far less stringent.
50. Naturally, regional initiatives also have potential disadvantages compared to other strategies. First, while conditionality is low, it still exists. Therefore, if a country is very zealous about its financial policy space, then it might prefer to

³⁹ The ASEAN+3 group consist of the ASEAN members (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) and China, Japan and Korea.

⁴⁰ The 20% threshold may seem low, but in the original agreement the threshold was set at 10%. In 2005, after several discUS\$ions among members, it was decided to raise it to 20%.

⁴¹ A one-way swap allows country A to swap its currency with country B reserves, but not the reverse. A two-way swap also allows country B to swap its currency with country A.

⁴² Source : own calculations based on Titelman (2006)

accumulate reserves individually than cooperatively. Second, the extent of risk sharing in regional agreements is limited, since external shocks to neighbor countries are usually correlated⁴³. Third, the funds available through regional initiatives are lower than those potentially available through the IMF. However, these theoretical disadvantages have not had significant impact in the existing arrangements. The level of conditionality has been negligible, and member countries have honored their debts with regional emergency funds even when defaulting on external debt. Regional agreements have also supplied more funds than other official creditors in emergencies, and their financial health was resilient to major regional crises.

C. The role of international financial institutions and agreements for preventing crises

51. International arrangements have the largest potential to prevent crises and mitigate their effects, mainly through preventive funding and coordinated regulation. In the aftermath of the Asian crises, there was widespread consensus on the need of a reform to the international financial system, and several plans were sketched. At the center of these initiatives were the reform of the IMF and/or the creation of new global institutions with specific crisis-prevention purposes⁴⁴. However, as time went by the political energy for sustaining these reforms dwindled.
52. The IMF, as a multilateral institution that has the specific purposes of promoting exchange rate stability and correcting balance-of-payments imbalances of its members, can play a decisive role in reducing external vulnerability and mitigating the effect of crises. It has different mechanisms through which it could contribute to crisis prevention: (1) multilateral surveillance: by providing analysis and advice on macroeconomic and financial policies of member countries, and (2) providing emergency financing by using part of its US\$ 179 billion of loanable funds⁴⁵ - essential not only to prevent or mitigate the consequences of crisis, but also to avoid contagion.
53. However, due to its poor performance in past crises, the conditions embedded in its loans –which usually are beyond its mandate and expertise-, and its anachronic governance, developing countries have lost their confidence in it. Moreover, the IMF even contributed to increase volatility in developing countries, acting as a cheerleader for capital account liberalization without sufficiently highlighting the risks of an open capital account (Independent Evaluation Office, 2005). As a consequence, the IMF has become increasingly irrelevant: many prominent IMF debtors have decided to pay off their debts with it, and several alternatives that carry out particular IMF functions have emerged (Kapur and Webb, 2004).

⁴³ See Imbs and Mauro (2007)

⁴⁴ For example, a global central bank, a sovereign bankruptcy court.

⁴⁵ As of July 31, 2006. Source : “Factsheet : How the IMF Helps to Resolve Economic Crises ?”, available at <http://www.imf.org/external/np/exr/facts/crises.htm> (accessed October 2007)

54. To regain the confidence of developing countries and become an effective crisis-prevention institution, the IMF needs to undergo deep strategic and institutional changes. The most obvious is a reform in its governance that gives more voice to developing countries to ensure that the IMF becomes better able to reflect current economic reality, in which developing economies represent a larger share of the world economy, and thereby also give commensurate voice to the developing world. The IMF also needs to reform its basic functions, especially in terms of its international monetary policy surveillance function and its application of such surveillance to the monetary policies of large non-IMF borrowing countries (especially developed countries) that may have global financial implications. It can also look seriously into the establishment of international emergency financing mechanisms that countries facing fiscal pressures as a result of increased volatility of financial flows arising from liberalized capital accounts could access.

V. Conclusion

55. The recent new dynamic of capital flowing from the South to the North at levels unprecedented since the period of colonization raises questions on many levels:

- First, it calls into question the whole concept of the capital resource gap which is being used by developed countries as the basis for promoting the liberalization of foreign direct investment regimes in and the provision of conditionality-laden aid to developing countries;
- Second, it also calls into question the entire international financial architecture that, because of its effectively deregulated nature, promotes and facilitates such South-North capital flows instead of encouraging the reinvestment of such capital into developing country economies for productive purposes;
- Third, it raises questions about the need for and how such dynamic should be increasingly reflected in terms of international economic policies and in the institutions that shape global economic policy – i.e. ensuring that Southern countries are collectively able to have a greater voice and more effective participation in global economic decision-making;
- Finally, it also raises questions about the relative degree to which Southern countries would now be able to effectively decouple themselves from continued reliance on Northern markets and Northern capital with respect to their own development.

56. The challenge for Southern countries, especially those with large reserve accounts, is in ensuring that long-term sustainable development gains accrue from the unprecedented level of domestic capital at their disposal. An additional challenge is in ensuring that such gains are equitably distributed both domestically and on a South-South basis (perhaps as a result of South-South cooperation). To meet these challenges in the context of the new dynamic of South-North capital flows (and the factors giving rise to such dynamic), Southern countries will need to be more strategic and development-oriented in terms of their management of their capital reserves not only for purposes of crisis prevention but also for purposes of development promotion.
57. This implies, for example, ensuring the strategic use of appropriate domestic capital account management and other financial policies in order to support each country's overall developmental goals. Improving levels of South-South regional and inter-regional economic, financial, and development cooperation with respect to effectively harnessing Southern capital for long-term south-South developmental purposes could be another key component. International action in terms of reforming and improving the international financial architecture will also be essential in order to ensure that development gains will not be jeopardized by unstable global financial imbalances leading to financial crises.

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Annex I. Net capital flows and current account in developing countries, 1998-2007
(US\$ billions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Southern Economies									
1. Current account balance	-86.70	-19.10	69.30	22.40	71.00	147.50	208.70	403.40	534.10
2. Private capital flows, net	44.04	51.72	45.55	52.03	18.46	102.81	156.21	102.06	68.99
2.a. Direct investment, net	135.15	149.98	142.24	153.90	122.96	143.76	142.59	201.71	167.95
2.b. Private portfolio flows, net	35.85	55.65	18.38	-79.68	-92.96	-18.13	-9.97	11.56	-98.29
2.c. Other private capital flows, net	-	-	-	-	-	-	-	-	-
3. Official flows, net	37.79	26.74	-29.97	5.46	20.25	-30.55	-43.92	-92.14	106.33
4. Change in reserves (negative sign is an increase)	-31.39	-79.79	-104.94	103.12	-165.32	315.63	440.78	466.32	590.22
Net financial transfers (2+3+4)	50.44	-1.33	-89.36	-45.64	-126.61	243.37	328.50	456.40	627.56
Africa									
1. Current account balance	-19.40	-15.00	7.20	0.50	-7.50	-2.20	0.60	14.60	19.90
2. Private capital flows, net	8.97	9.00	-4.16	2.18	0.91	2.70	12.32	18.29	20.18
2.a. Direct investment, net	6.35	8.58	7.62	23.13	13.47	15.37	16.77	26.98	19.14
2.b. Private portfolio flows, net	4.28	9.11	-1.76	-7.94	-1.58	-0.51	5.36	4.11	18.48
2.c. Other private capital flows, net	-1.65	-8.70	-10.03	-13.02	-10.99	-12.15	-9.81	-12.80	-17.43
3. Official flows, net	5.04	4.09	7.75	6.47	8.55	6.37	4.27	-1.80	-3.83
4. Change in reserves (negative sign is an increase)	3.50	-0.39	-12.79	-9.66	-5.49	-11.43	-32.67	-42.27	-48.43
Net financial transfers (2+3+4)	17.51	12.69	-9.20	-1.01	3.97	-2.35	-16.09	-25.79	-32.08
Table 1.3 (continued)									
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Developing Asia									
1. Current account balance ^a	49.30	38.30	38.10	36.60	64.60	82.50	88.50	165.20	253.10
2. Private capital flows, net	-53.20	-1.94	4.52	23.47	25.41	69.23	142.52	69.74	53.87
2.a. Direct investment, net	56.99	70.93	59.75	52.04	52.63	73.05	67.95	105.78	102.36
2.b. Private portfolio flows, net	8.99	54.11	19.60	-50.16	-60.06	7.75	11.15	-8.13	-99.39
2.c. Other private capital flows, net	-	-	-	-	-	-	-	-	-
3. Official flows, net	119.18	126.97	-74.83	21.59	32.84	-11.58	63.41	-27.91	50.89
4. Change in reserves (negative sign is an increase)	19.32	8.53	-10.89	-12.05	4.11	-16.59	-7.00	-2.77	-9.76
4. Change in reserves (negative sign is an increase)	-52.67	-84.80	-59.12	-85.44	-154.30	234.35	339.01	284.09	365.56
Net financial transfers (2+3+4)	-86.55	-78.21	-65.49	-74.01	-124.78	181.71	203.48	217.12	321.46
Middle East									
1. Current account balance ^b	-26.20	14.00	72.10	39.20	30.00	59.50	99.20	189.00	212.40
2. Private capital flows, net	14.42	-3.80	-9.99	-5.48	-19.39	4.70	-11.98	-19.87	-15.48
2.a. Direct investment, net	9.63	4.39	4.88	12.28	9.65	17.81	8.77	17.57	11.99
2.b. Private portfolio flows, net	-4.03	-8.59	-1.20	-13.50	-17.41	-14.91	-13.99	-14.91	-4.95
2.c. Other private capital flows, net	8.82	0.40	-13.67	-4.25	-11.63	1.80	-6.75	-22.53	-22.51
3. Official flows, net	-0.36	7.98	-20.46	-14.15	-9.78	-24.64	-32.50	-57.13	-75.02
4. Change in reserves (negative sign is an increase)	8.70	-1.96	-31.23	-11.57	-3.11	-33.66	-45.71	106.59	129.72
Net financial transfers (2+3+4)	22.76	2.22	-61.68	-31.20	-32.28	-53.61	-90.18	-	-

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Latin America									
1. Current account balance	-90.40	-56.40	-48.10	-53.90	-16.10	7.70	20.40	34.60	48.70
2. Private capital flows, net	73.85	48.46	55.18	31.86	11.53	26.19	13.34	33.91	10.41
2.a. Direct investment, net	62.19	66.09	69.98	66.45	47.21	37.53	49.10	51.39	34.47
2.b. Private portfolio flows, net	26.61	1.02	1.73	-8.08	-13.91	-10.46	-12.49	30.50	-12.43
2.c. Other private capital flows, net	-14.95	-18.65	-16.54	-26.51	-21.77	-0.89	-23.27	-47.97	-11.63
3. Official flows, net	13.80	6.15	-6.36	25.18	17.37	4.31	-8.70	-30.43	-17.72
4. Change in reserves (negative sign is an increase)	9.08	7.36	-1.80	3.54	-2.43	-36.19	-23.39	-33.38	-46.50
Net financial transfers (2+3+4)	96.72	61.98	47.02	60.59	26.48	-5.70	-18.75	-29.90	-53.81

Source: International Monetary Fund, World Economic Outlook Database, April 2007

^a Does not include Korea, Taiwan, Singapore and Hong Kong.

^b Does not include Israel.

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