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Global financial integration and development and recent issues

Note by the Secretary-General

The purpose of the present note is to assist participants by identifying some issues relating to global financial integration and development that might be addressed in the discussions. Speakers may wish to focus special attention on the longer-term and development aspects of these issues.

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I. Introduction

1. Private international financial flows to developing countries increased from $64 billion in 1990 to $235 billion in 1996 but fell to an estimated $172 billion in 1997.[1] There has been growth not only in the volume, sources and destinations of international flows but also in the agents, types and modes of such flows, resulting in an unprecedented degree of financial interdependence among countries, with dependencies running from source countries to recipient countries and vice versa. This process of global financial integration has been fuelled primarily by the liberalization of markets and technological progress.

2. The experience of East Asia over the past decade has demonstrated the positive contribution that international financial flows can make to development, while the region's more recent experience has revealed the challenges that they can pose. Such experience provides lessons not only for the countries concerned but also for the many other countries that have been affected by recent developments and for countries in the process of becoming integrated into international financial markets.

3. Discussions might focus on such lessons, in particular the respective roles of national Governments, financial markets and international organizations in addressing global financial integration and its effects. Some of the issues that might be addressed are identified below.

II. The challenges of global financial integration

A. The national economic and financial environment

4. Effective integration into global financial markets requires sound macroeconomic conditions and a sound domestic financial sector. Such conditions are not only conducive to international financial flows but also reduce the threat of financial crises. The meeting could examine the nature of these prerequisites for effective integration into global financial markets.

5. In the absence of information about local conditions in foreign markets, a change in perceptions can precipitate a disproportionately large reaction in financial markets. The

widespread availability of more timely, accurate and comprehensive data and other information about conditions in national economies and within financial and commercial establishments should contribute both to effective economic decision-making by Governments and to the efficiency of financial markets. The meeting could address the extent to which the availability of such information, in and of itself, would reduce volatility in individual markets and contagion across markets, as well as the role of Governments and international institutions in establishing standards for and ensuring the widespread availability of such information.

B. Monitoring and oversight

6. Interdependencies among countries create a common global interest in avoiding all potential threats to financial stability. This objective can be served by multilateral mechanisms that monitor all national economic policies affecting international capital flows and other monetary and financial variables. Since neighbouring countries are among those likely to be most affected by a national financial crisis, such arrangements might have a regional as well as an international dimension. The nature and operation of such collective oversight mechanisms could be addressed.

7. Because unsound practices by banks and similar institutions can pose a threat to the economy at large, developed countries and many developing countries have an array of prudential, supervisory and regulatory arrangements for strengthening competition and the discipline of the market on the financial sector. Many of these arrangements have been enhanced and harmonized among countries in response to the evolution of financial markets. The meeting could consider the nature of the national and international regulatory mechanisms required to take into account the increasing participation of developing and transition economies in world financial markets.

C. Contingency arrangements

8. Uncertainty about the future, possible policy weaknesses on the part of Governments and exuberant behaviour on the part of markets make it difficult to eliminate the incidence of financial crises. Such crises need to be addressed as promptly as possible because they become more pronounced (and correspondingly more difficult and costly to resolve) the longer they are left unattended. Moreover, with the continuing expansion of financial markets, such crises as do occur are likely to require a greater effort to resolve than in the past. The meeting could consider whether current international contingency arrangements are adequate in the light of the increasing volume of international financial flows.

III. Responding to financial crises

A. Sharing risks and responsibilities

9. Official measures to reduce the adverse short-term effects and economy-wide threats posed by a financial crisis may result in some private-sector risks being transferred to the public sector, which may encourage private financial entities to take on more risks than would otherwise be the case. In confronting a crisis, Governments and international institutions are faced with a choice: they can allow the crisis to deepen, with the result that those who have taken excessive risks bear the full cost of their decisions but many others will also be adversely affected, or they can mitigate the effects of the crisis, in which case lenders and borrowers may not have to assume the full cost of their decisions but others would also be less seriously affected. Arrangements for the equitable sharing of the costs of resolving financial crises could be addressed.

B. Protecting vulnerable groups

10. Financial crises can result in bankruptcies, increased unemployment and other economic hardships. Particularly for vulnerable groups, the suddenness of the crisis is likely to exacerbate these difficulties, and not fully tackling them is likely to lead to broader negative effects, such as crime and heightened political tensions. The meeting could consider ways in which such short-term dislocations and their effects on vulnerable groups should be addressed in the context of major financial crises.

C. Safeguarding long-term development

11. Managing a financial crisis requires focusing on immediate problems, with the danger that longer-term and broader concerns may suffer relative neglect. Although all unproductive expenditures need to be eliminated, efforts must be made to preserve sound investments, including those which do not yield any immediately identifiable return in the short run but which are indispensable to long-term development, such as expenditures on human capital. In addition, care needs to be taken to preserve some of the broader dimensions of development that may come under

stress, such as human rights, institutional development, participation and democracy. The challenge of meeting short-term imperatives without overlooking longer-term priorities could be addressed.

Notes

[1] See International Monetary Fund, *World Economic Outlook: Interm Assessment*, December 1997, table B.8.