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Costs of Currency Crises and Benefits of International Financial Reform

A UNDP/ODS Background Paper

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I. Introduction

The existing imperfect and incomplete international financial system underprovides the global public good of financial stability (Conceição 2003, Griffith-Jones 2003). As has been amply discussed volatile and reversible capital flows are a major determinant of developmentally and financially costly currency and banking crises in developing countries. This has implied massive cumulative losses of output (see our estimates below), as well as large fiscal costs related particularly to resolving banking crises (for excellent overviews, see IMF 1998 and Mendoza 2002).

Less often stressed, many mainly poor developing countries have insufficient access to private and public flows most of the time, which constrains their growth. Furthermore, even so-called emerging market countries suffer long periods of drought of capital flows, often after they or other emerging countries have suffered crises (Ffrench-Davis and Griffith-Jones 2003), which implies that the international financial system also underprovides the global public good of market efficiency. This also leads to lower growth of developing countries than would otherwise occur. The lower growth in the latter two cases is more difficult to estimate, even though it is also important.

For a fuller estimate of total costs, it would also be important to include the impact on lower growth in the developed world, caused by the fact that their investment and trading opportunities in the developing world are below their potential level. At a time where large parts of the developed world, and particularly much of Europe and Japan, are growing very slowly and have quite high levels of unemployed resources, the cost for them of lost growth in developing countries is particularly high.

These high costs of an imperfect international financial system are by no means inevitable. As many have argued, a number of reforms could be introduced to the international financial system to make it contribute more and better to growth and development (see Griffith-Jones and Ocampo 2003 for one recent contribution). In most aspects, introducing such reforms would have zero or very low costs, and certainly far lower than the cost of inaction.

In this paper, we will first (section II) estimate the cost (due both to crises and insufficient access to private as well as official flows) of the current system. In section III, we will estimate the costs (where these exist) of different reforms of the international financial architecture that would hopefully eliminate or significantly reduce the costs estimated in section II. We will concentrate more on these reforms that have low or zero costs, and that will therefore allow all countries and actors to emerge as net gainers (Williamson 2004). Section IV concludes by estimating and examining the balance between costs and benefits of reforming the international financial system, by comparing the costs of inaction with the costs of corrective action and the resultant benefits.

II. Costs of Crises

The costs of excessive financial instability leading to crises are massive; they can take different forms, as mentioned earlier. A key cost is forgone output. In what follows we estimate the output loss emerging market countries suffered in the second half of the 1990s and early this century, as a direct result of major currency and twin crises. The countries are Argentina, Brazil, Indonesia, Korea, Malaysia, Mexico, Thailand and Turkey. Just for those countries for the 1995-2002 period, we estimate a total loss of US\$ 1.250 billion, that is an annual average of around US\$ 150 billion for that period.

Output loss caused by financial crises can be measured in a variety of ways. First, one can quantify the loss of output incurred during the crisis period. Alternatively, one can measure the cumulative output loss that occurs over time due to a lower output level or trend during and after a crisis episode. Cumulative output loss, in turn, can be measured either by summing up the annual difference between potential growth rates and observed growth rates, or by summing up the differences in output levels (Hoggarth and Saporta, 2001). Previous studies have attempted to estimate cumulative output loss resulting from financial crises by looking at the difference between growth rates, e.g., IMF (1998) and Aziz et al. (2000). However, Hoggarth and Saporta (2001) correctly point out that measuring the difference in output levels rather than growth rates leads to a better estimate of the loss of output actually incurred. Accordingly, they suggest a methodological approach for the former type of measurement.

We estimate cumulative output loss by measuring the difference in output levels, thus adopting a methodological approach similar, although not exactly the same, as that suggested by Hoggarth and Saporta (2001). Specifically, we measure the cumulative difference between projected potential output and actual output over the years, starting from the first crisis year. Potential output is represented by the country's output trend over the years preceding a major crisis episode. The period upon which the output trend is based varies from country to country, and is six years at least¹. The use of at least a six-year period is intended to reduce the possibility of overestimating the output trend in those cases where growth accelerates in the years immediately preceding the crisis episode².

¹ Other studies calculate their trends over a shorter pre -crisis period – between 3 and 5 years (see Hoggarth and Saporta, 2001).

² The output trend corresponds to the fitted values of a linear regression of the real GDP level variable regressed on a time trend plus a constant. All estimated trends have a high degree of fitness.

Table 1 provides information on both the years used for estimating the output trend and the years from which cumulative output loss is derived, for each crisis country. In addition, it provides the initial crisis date.

Table 1. The Crisis years, output trend period and period of cumulative output loss

	Initial crisis date	Period used for estimating output trend	Years of cumulative output loss
Argentina	December 2001	1991-2001	2002
Brazil	January 1999	1991-1998	1999-2002
Indonesia	July 1997	1991-1996	1997-2002
Korea	October 1997	1991-1996	1997-2002
Malaysia	September 1997	1991-1996	1997-2002
Mexico	December 1994	1989-1994	1995-2002
Thailand	July 1997	1991-1996	1997-2002
Turkey	June 2001	1991-2000	2001-2002

Looking at Table 1, it is possible to see that the periods used to calculate cumulative output loss vary significantly across countries. This is due to the different starting crisis dates. The first emerging market financial crisis in the 1990s started in Mexico in December 1994. Therefore, for Mexico the cumulative output loss is calculated over the 1995-2002 period, the longest of all. The latest crisis has been Argentina's crisis starting in December 2001. Therefore, for this country the output loss is calculated for the year 2002 alone.

Table 2. Cumulative output loss for each crisis country³

	Period of cumulative output loss	Estimated output loss U\$ 1989 billion	Estimated output loss U\$ 2002 billion
Argentina	2002	25.6	37.1
Brazil	1999-2002	96.7	140.1
Indonesia	1997-2002	238.6	345.9
Korea	1997-2002	122.9	178.1
Malaysia	1997-2002	60.6	87.8
Mexico	1995-2002	78.1	113.2
Thailand	1997-2002	210.5	305.2
Turkey	2001-2002	29.0	42.1
Total		862.0	1249.6

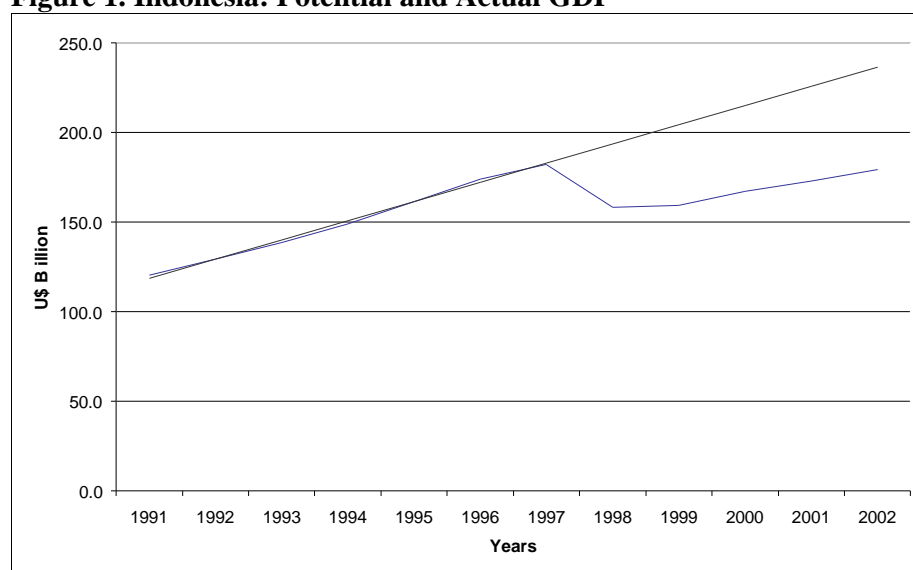
Source: author's elaboration, based on World Bank data base.

³ Table 2 displays numbers both in 1989 U\$ billion 2002 U\$ billion, in the former case to make them directly comparable with the numbers displayed in the figures displayed in the text, which are also in 1989 U\$ billion.

From Table 2 it is possible to see that the total output loss incurred during 1995-2002 by the 8 emerging market countries under examination over the years following a major currency (or twin) crisis amounts to US\$ 1.25 trillion. Just to give an idea of proportions, this amount of forgone output corresponds to 54% of the combined GDP of East Asia & Pacific region, and 65% of the combined GDP of Latin America and the Caribbean.⁴ Of course, the poorer economic performance observed among the countries after a major crisis episode may not be attributed to the crisis alone. But it is clearly consensus that the crises have been the preponderant factor behind it.

The biggest estimated loss has been incurred by Indonesia – of US\$ 346 billion, where it is well known a very major economic crisis took place as a result of the Asian debacle of 1997, and where actual output has since then remained far below its potential level, as clearly illustrated by Figure 1 below.

Figure 1. Indonesia: Potential and Actual GDP



Note: Projected output for the years 1997-2002 based on output trend over the 1991-1996 period. Values are in US\$ 1989 billion. Data source: World Bank data base.

⁴ We also calculated output loss by extrapolating output based on past average growth rates. This approach led to even higher numbers.

It is important to emphasize that Indonesia experienced larger falls in output and incomes during and after its crisis than that of the United States in the Great Depression. Equally or more disturbing, poverty in Indonesia increased from 7-8% in 1997 to 18-20% in 1998 (Suryahadi et al, 2000).

The other Asian countries also witnessed major output loss, mainly because, as has been the case of Indonesia, actual output by 2002 had not returned to their potential level. This is the case even in Korea, where economic recovery among all crisis affected countries has been the most robust.

Table 2 also shows that between 1995 and 2002 the estimated output loss among Latin American countries is smaller than among the Asian countries. This is mainly for two reasons. First, they are based on a smaller number of years (except for Mexico). Second, the inclination of the output trends are underestimated for including years of recession, some of which were caused by contagion effects of crises occurred elsewhere (either in neighbouring countries or in East Asia). In particular, Argentina saw its GDP fall by 3% in 1995, linked to the Mexican crisis; its GDP fell in 1999 and 2001 (by over 3 and 4% respectively), due partly to the Brazilian crisis and partly due to its adjustment linked to trying to unsuccessfully avoid the major currency and banking crises that occurred in 2001, which led to a fall in GDP of almost 11% in 2002 (naturally, Argentine's crisis was also linked to its inappropriate policies, especially the exchange rate regime). In the 1980s, Latin America had been the region where the cost of debt crises was highest, though Sub-Saharan Africa also suffered major, though more silent, debt crises.

Thus, according to our estimates, for 1995-2002 (admittedly a period when crises were both very damaging and very frequent), the annual cost of crises reached the very large estimated amount of US\$ 150 billion (in 2002 US\$).

The amount we estimate is higher than that estimated in Mendoza (2002), but this difference seems explained by the fact that Mendoza focuses on banking crises, whilst we focus on currency (and twin) crises –the two latter more directly linked to faults in the international financial architecture-, which are even costlier; also Mendoza takes a longer period (1970-2000), which includes the 1970s with practically no crises; finally, as explained above a somewhat different methodology is used. These factors explain why, though different, our results are fairly consistent with those presented in Mendoza (2002).

Our estimates of the direct costs of crises may seem rather high. However, the order of magnitude is similar to other estimates. Most recently, Eichengreen (2004) has estimated the cost of currency crises at 0.7 per cent of developing country / emerging market GDP per year, equivalent to an annual amount of US\$ 107 billion, a figure not so different from ours. It is interesting that Eichengreen's estimates draw both on historical work that estimates output losses partly by examining crises during the last 120 years (Bordo, Eichengreen, Klingebiel and Martinez-Peria 2001) and on a study by Dobson and Hufbauer (2001) that looks at average output losses per year during the 1980s and 1990s in Latin America and Asia (the latter using a different approach to the former, but reaching similar orders of magnitude)⁵. Eichengreen (2004) estimates that over the last quarter century, currency and banking crises have reduced incomes of developing countries by around 25 per cent.

These estimates dramatically show the extremely high economic, social and human cost of the under provision of the global public good of financial stability.

Although very high, and clearly far, far higher than any estimated cost of providing financial stability (see below), our estimates in Table 2 of US\$ 1.25 trillion for the 1995-2002 period underestimate total costs associated with financial crises. They do not take account of either lower economic growth in developing countries, due to contagion effects via the financial channel (e.g. Argentina in 1995), or lower growth in crises countries via the trade channel due for example to lower prices of exports and declines in volumes of exports (e.g. for Sub-Saharan African countries, as a result of the East Asian crises –see Harris 1999).

Furthermore, these estimates do not take account of lower growth in rich countries due to missed trade opportunities and investment with crisis affected countries. UNCTAD (1986) estimated that as a result of the debt crisis, more than seven million jobs may have been cumulatively lost in the industrial countries during 1982-85, as a result of their declining exports to developing countries, linked to an important extent to the debt crisis. Griffith-Jones, Marcel and Palma (1987) estimated that for the UK alone, direct job losses due to lower exports to developing countries linked to the debt crises were at least 200,000 annually; British exports to Latin America in 1985 were 45 per cent lower than in 1980.

⁵ Other empirical studies reach broadly compatible conclusions. See, for example, Goldstein, Kaminsky and Reinhart (2000).

III. Are costs of reforming the international financial system significant?

In our discussion, we will estimate costs of reforms to the international financial system that would prevent or significantly reduce the risk of crises, as well as some measures that would allow them to be managed better.

1. Better financial regulation and capital controls

As regards crises prevention, one of the areas where most policy actions have already been taken is helping strengthen countries' capacity in financial management and regulation. The cost of technical assistance for this purpose is fairly low at around US\$ 100 million, as Mendoza (2003) has pointed out. Any increase, which may be desirable, would also imply relatively low amounts, certainly low in terms of the cost of crises discussed in section II. Far more significant but also much more difficult to estimate, are the costs to developing countries themselves of strengthening and updating regulation, especially given the complexity of domestic financial systems and of international regulations, such as the new Basle 2. To the extent that the regulations introduced genuinely reduce the risk of crises (and there are doubts for example on the impact of Basle 2, see Griffith-Jones, Spratt and Segoviano 2004), then the costs of improved regulation borne by developing countries also clearly outweigh the benefits of fewer and less deep crises. It should however be emphasized that improved domestic financial regulation will certainly not by itself be enough to prevent crises.

A complementary measure to be taken nationally to reduce the risk of crises is –in times of excessive surges of capital flows, which have not occurred much recently– to introduce capital account regulations; these can for example be unremunerated reserve requirements (URR), such as Chile, Colombia and Slovenia introduced, that created a simple, non-discretionary and preventive (prudential) price-based incentive that penalized short-term foreign currency liabilities more heavily. There is agreement that such measures had the clear benefit of improving the maturity structure of debt profiles, thus making crises less likely; there is also quite solid evidence that they influenced the level of capital flows, and therefore interest rates and exchange rates, that help avoid creating imbalances, which may also make later crises more likely –another clear benefit (Ocampo 2003, Le Fort and Lehman 2003). As has been suggested by Williamson (2004), countries should not only be permitted to take such measures, but the IMF should actively encourage the use of such controls in periods of excessive inflows.

As regards possible costs, these would really be in terms of less revenue during surges for international lenders (especially for short-term loans) and by speculators. International lenders would either make less profit on loans they made and/or make less loans, during periods of surges. To the extent that these measures would reduce the likelihood of crises such international lenders would be likely to suffer less losses (and these could be significant) due to future crises. Successful de-stabilizing speculators may lose some of their profits, but surely this is not a source of major concern to those promoting development and international financial stability. Price-based disincentives on excessive inflows are unlikely to have costs for the developing countries that implement them; the experience of Chile seems to show clearly that the URR did not discourage deepening and development of the domestic financial market.

Furthermore, both the improvement of financial regulation (discussed above) and price-based prudential capital controls would have the benefit of reducing the risk of crises, which have very high costs for developing countries and also potentially high costs for developed countries, via indirect impact on their own growth and direct potential costs of crises management.

2. Counter-cyclical and enhanced official liquidity

At a country level, for many decades, Central Banks have acted as lenders of last resort, to prevent systematic banking or other financial crises, or to avoid them deepening. Internationally equivalent mechanisms are still at an embryonic stage, though increasingly necessary to help prevention and deepening of crises and their contagion. To put it more modestly, official liquidity needs to be enhanced significantly, given the rapid growth and volatility of private flows, which can lead to such very costly crises (see section II above) and such official liquidity should be particularly increased in a counter-cyclical manner.

There are different ways in which international official liquidity can be enhanced, and some of these ways can be combined.

a. SDR issues

Conceptually, though not necessarily politically, one of the simplest and least costly ways in which official liquidity can be enhanced in a counter-cyclical manner or in a more sustained way, is via issue of SDRs.

Currently, some developing countries (especially but not only in Asia) hold extremely high and growing levels of foreign exchange reserves, and these reserves have increased dramatically since recent crises, partly to protect themselves against the risk of future crises due to the potential reversibility of capital flows (however, the other reason why some of these countries hold such high levels of reserves is their wish to avoid over-valuation of their currencies). Even low-income countries hold quite significant reserves – in proportion to their economies – as poor countries have not only need for development finance, but also official liquidity, to smooth or reduce the burden of adjustment if they face external (e.g. terms of trade) or domestic (e.g. drought) shocks, and to avoid the risk of currency crises. The fact that developing countries of different categories hold such high levels of reserves, with the aim of “self-insurance” implies high costs for them, which are particularly onerous for low-income countries. Polak and Clark (in this volume) estimate the significant cost of holding reserves for low-income countries at around US\$ 10 billion a year.

There is therefore a clear “need” for different categories of developing countries to have higher internationally issued reserves; as we will show such “collective insurance” would be cheaper and therefore more efficient for developing countries than “self-insurance” via own reserves, as practised now.

From a conceptual perspective, SDRs could be issued in one of two manners, to help satisfy the liquidity needs of developing countries. Firstly, they could be issued in a temporary way during episodes of financial stress, and could be destroyed once financial conditions normalize (Council on Foreign Relations 1999, Camdessus 2000, Griffith-Jones and Ocampo 2003). This would develop a counter-cyclical element in world liquidity management, as reduced private lending would be partly compensated by increased official liquidity;

furthermore, total long-term liquidity would not increase, since normalization of private lending would imply repayment of extraordinary IMF loans, which would imply a destruction of the SDRs, through which they were financed. Output in developing countries would be higher than otherwise, and the risk of additional world inflation would be totally minimal.

A second manner of issuing SDRs would be to provide permanent allocations, either of a general kind to all the membership or, as industrial countries do not need SDRs, only to developing countries which do have a rising demand for reserves. Furthermore, the currently existing alternative of developing countries holding such higher reserves –and obtaining either through borrowing from international capital markets or by generating larger trade surpluses or smaller trader deficits – can be very costly, both in financial terms and in terms of real resources, lower growth and higher poverty.

For developing countries, holding additional SDR reserves –should these be allocated to them– would have a zero net cost or even a net benefit, as payment by the country for its reserves would be equal or lower to the interest earned if it holds them (Polak and Clark in this volume⁶).

There would also be no fiscal cost to industrial countries if the IMF issued SDRs. Indeed, if an industrial country is allocated SDRs –should the allocation of SDRs be a general one– it will also either have zero net costs, or even a small positive net benefit. Taking the UK as an example, in financial year 2002-03, £ 1.6 billion was being held from its past allocation of SDRs. The UK held on average £ 0.2 billion in SDRs and £ 1.4 billion in foreign currency. The UK paid interest to the IMF on its full allocation, and received interest on its SDR part as

⁶ I also thank John Drage for perceptive comments on this.

well as receiving interest and having capital gains on its foreign currency holdings in which it had invested its SDR allocation. UK Treasury (2004) estimates the total net gain of £ 28 million for the UK Treasury for 2002-03. Therefore, allocations of SDRs to industrial countries signify no cost to them, and if well invested may even represent a small gain.

One of the main reasons for traditional opposition to some industrial countries to SDR issues is that these could increase inflation globally. This has always seemed a very exaggerated concern, as the amount of SDRs that would be issued would be an extremely small proportion of the world's total money supply. For example, in the most recent allocation of SDRs discussed, but not yet approved, the Fourth Amendment to the Fund's Articles of Agreement proposed an issue of SDR 21 billion; the US \$ equivalent of this is approximately US\$ 30 billion. If we compare, for example, with the US total money supply (M_2) of US\$ 6.184 billion (which is significantly less than the world money supply), the amount of possible SDR issue is less than 0.5% of the US money supply, and therefore far less than the world's total money supply.

However, concern about inflation is particularly irrelevant at the time of writing, as both inflation globally and particularly real interest rates in several of the major industrial countries are rather low and there is thus not too much room to increase liquidity via monetary policy. Therefore, issuing additional liquidity, via SDRs, could be justified from a developed country perspective, for example for a country like Germany, which has high unemployment partly caused by insufficient aggregate demand that cannot be easily increased by fiscal policy. If an SDR issue led to increased imports from developing countries, the resulting exports could help increase aggregate demand in such a country and lead to non-inflationary increases in output and employment.

Currently the main source of the large increase in foreign exchange reserves that developing countries have accumulated is the US current account deficit. However, the US government itself –as well as many others, including those who help fund it–are concerned about the size of the US current account deficit, and the need to reduce it. In this context, the US could become more sympathetic to an SDR creation due to its own self-interest. Greater SDR liquidity could allow other countries, including developing countries, to relax their efforts at increasing current account surpluses (Williamson 2004). Furthermore, it would somewhat help reduce the massive dependence of the US on Asian foreign central banks financing its deficit, a dependence which may be or could become a source of concern to the US authorities.

Therefore, it is a very good point in time to revisit the argument in favour of issuing SDRs, not just because these could have clear benefits –and no costs– for developing countries, but also because there could be, particularly in the existing environment, benefits –and no costs– also for developed countries.

b. Improving IMF lending facilities to help crises prevention and improve crises management

An alternative, or complementary, role to increasing official liquidity via SDR issues is to expand the counter-cyclical role of the IMF through the creation, expansion or improvement of its facilities for these purposes. For middle-income countries, this could imply for example the creation of a more effective “son / daughter” of the suspended Contingency Credit Line (CCL), that would help prevent or moderate capital account led crises.

Such a “new” CCL could be automatically available to all countries that were very favourable evaluated by the IMF in their Annual Article IV consultations, if they had balance of payment problems arising from international financial contagion. An alternative would be that after a positive evaluation in Article IV consultations, a country would become eligible for a “new” CCL. The fact that countries would be named as eligible for the “new” CCL by the IMF would make it a sign of strength (indicator of good policies) rather than a sign of possible future weakness, which the “old” CCL was perceived to be.

For middle income countries it could also imply liberalizing the very high conditionality linked to the Compensatory Financing Facility (CFF), which can help countries compensate for terms of trade shocks, and thus allows for more growth, by reducing the temporary burden of adjustment⁷, in a context where capital markets suffer from imperfections and tend to behave procyclically. Research at the World Bank, reported in “Global Economic Prospects and the Developing Countries” (2000) shows that fluctuations in income growth can have an asymmetric impact on poverty; thus, a one per cent contraction in per capita income increases poverty more than the equivalent increase in income reduces poverty. Therefore, consumption smoothing, particularly for the poor, can generate large welfare gains, as can maintaining vital investment expenditure.

Furthermore, the evidence on the adverse effects of terms of trade shocks on economic growth is also strong. Particularly important is the finding that the secondary effects of negative shocks in terms of trade can be very large (Collier and Dehn 2001).

⁷ Since its’ modification in early 2000, which basically tightened circumstances for unconditional access to the CFF, the CFF has not been used, in spite of two temporary and exogenous shocks affecting several developing countries. See IMF (2003) Fund Assistance for Countries Facing Exogenous Shocks. IMF website.

The changes required would not only imply modifications of the facilities, but also –where appropriate- reducing and streamlining their conditionality and making it more effective in supporting growth.

The creation, expansion or improvement of such IMF facilities like a “new” CCL and/or an improved CFF for middle-income countries would have no cost at present. There is no subsidy element involved, and the Fund has at present ample liquidity, as shown below.

Indeed, at the end of 2003, the Forward Commitment Capacity (FCC) –established in 2002 as the clearest indication of resources available to the IMF for new lending operations– reached at least SDR US\$ 54 billion (see Table 3 and footnote 1 therein, as well as UK Treasury 2004).

Table 3

	Billion US\$ SDRs (end 2003)
IMF Uncommitted Usable resources	77.9
<u>Plus</u> projected Repurchases one year forward	9.2
<u>Less</u> Prudential Balance (1)	-32.8
<u>Equals</u> one year Forward Commitment capacity	54.2

Source: UK Treasury 2004

(1) The prudential balance is set at 20 per cent of quotas of member countries whose currencies are currently used in IMF lending. It is not a rigid amount, and thus the Forward Commitment Capacity could be temporarily increased.

In fact, the Forward Commitment Capacity could temporarily even go above the US\$ 54 billion SDRs, as the prudential balance is estimated on a somewhat conservative level.

Additionally to the liquidity available within the IMF, there are sources of supplementary financing, -the New Arrangements to Borrow (NAB) and the General Arrangements to Borrow (GAB)- which reach SDR US\$ 34 billion. Under these arrangements, major industrial countries and several emerging market countries have undertaken to make loans to the IMF if it needs additional financing. Again such loans do not bear a cost for developed countries, on the assumption they will be repaid (which is what has always happened till now).

Therefore, the IMF has very ample liquidity available (mainly based on its own resources), but also complemented by resources it can borrow from some of its member governments. Based on this liquidity, the IMF could in a costless way significantly expand its lending to middle-income countries, to further help prevent dramatically costly crises, to make these crises less serious if they do occur and to provide compensatory financing, if these countries face terms of trade shocks (“the silent crises”), so as to reduce the burden of adjustment. In all these cases, additional financing could provide for more growth and poverty reduction in developing countries.

As regards low-income countries, one of the most appropriate mechanisms to provide additional IMF funding if the country faced external shocks outside their control could be to increase significantly access under the PRGF arrangements (called PRGF augmentation in recent IMF analysis) and to diminish conditionality, as well as make the conditionality more supportive of growth and poverty reduction, by for example allowing - where feasible that is in post-stabilization countries with low levels of inflation - higher levels of government spending and particularly that which implies positive impacts on pro-poor growth (see Oxfam 2003, and Griffith-Jones and Ocampo 2003).

Given that about half the eligible low-income members have PRGF arrangements (IMF 2003) this would be an important channel. Using such augmentation of the PRGF would make such liquidity support subsidized for low-income countries. Augmentation of PRGF has been the main vehicle the Fund has used to provide financing for low-income countries hit by shocks. However, as the IMF (2003, op.cit.) itself recognizes clearly, “the small size and infrequency of PRGF arrangements suggests that there may be room for a more systematic response”. Indeed, in PRGF programmes where the Fund staff estimated the direct impact of the shock (on average 70% of quota), PRGF augmentation was very small in relation to the impact (only 12% of quota, that is less than a fifth of the IMF impact of the quota). These augmentations have also been very infrequent. It is therefore essential that there is a genuine liberalization of the PRGF, for it to be effective in helping low-income countries deal with external shocks, in ways that minimize costs to growth and poverty.

For low-income countries that do not have PRGF arrangements, but are eligible (around half), there are a number of options for financing shocks outside their control (“silent crises”); these options have been amply discussed recently in the IMF but as yet very little action has been taken. One option, which seems very appropriate, would be to liberalize access to the CFF, liberalize its conditionality and introduce a subsidy element into it for low-income countries. Another option, apparently favoured by the IMF Board, would be for PRGF eligible countries which do not have such a programme to be granted subsidized loans from the Fund via a stand-by like window, within the PRGF Trust (see IMF PIN 04/40, April 15, 2004). One reported advantage of the latter approach is that it would avoid the need for additional requests for donor resources and provide quite significant concessionality.

Overall, the key point is for higher levels of IMF lending to be available for low-income countries, for this lending to have light or no conditionality –as such shocks are by definition exogenous- and for the lending to be subsidized. This would significantly reduce the negative impact of “silent crises”, which as described above can have such a devastating impact on low-income countries’ growth and poverty.

The IMF itself (The Fund’s Support of Low-Income Countries; Considerations on Instruments and Financing, April 2004) admits that the resource requirements for the Fund’s concessional assistance, over the medium and long term, are “subject to considerable uncertainty”. This is partly because the modus operandi of these facilities’ financing is extremely complex, which makes it untransparent. However, it seems evident that till 2006, the Fund’s concessional lending at current levels can be funded from accumulated resources, the so called self-sustained PRGF. Indeed, this self-sustained PRGF could maintain PRGF (or similar) type of lending at about SDR US\$ 660 million (about half of current levels) in perpetuity. If higher levels were required now, and beyond 2006 (which reportedly would include an increase in concessional lending to deal with shocks), additional loans resources (at market interest rates) would be required, but, what is very positive, reportedly no additional subsidy resources would be needed, given existing reserves in the Fund. It would seem valuable, if in its next studies the Fund staff could evaluate and publish in as clear way as possible costs of significant increases of PRGF and PRGF related instruments, including both the need for additional loan resources and possible subsidy resources.

3. Creating new lending instruments to reduce risk of crises

Another way to reduce the risk of costly crises is to create lending instruments that deal with international financial market imperfections or incomplete international financial markets.

One such instrument would imply the creation or broadening of counter-cyclical official guarantees that would help smooth private lending, thus reducing the risk of reversals of capital flows provoking crises (see Griffith-Jones and Fuzzo de Lima, in this volume). Because guarantees would only cover certain risks and certain periods, the contingent liability they would generate for developed country governments or multilateral development banks could be significantly lower than the value of such guarantees. Nevertheless, they would have a potential contingent cost. Further study is required to estimate the value of such a cost.

Another instrument recently proposed (see Eichengreen 2004) aims to eliminate the currency mismatch in developing country borrowing, thus making those countries less vulnerable to costly crises. The idea is to facilitate developing countries borrowing in their own currency. Eichengreen and Hausman (2003) propose the creation of a synthetic unit of account, where claims on a diversified group of developing economies can be denominated; they suggest that the World Bank and other IFIs issue debt in such an index, and that they subsidize issuance till sufficient liquidity is created to make the new bonds easily tradable. Eichengreen (2004) estimates the temporary annual cost of such an initiative at between zero and US\$ 550 million per annum, depending on whether the World Bank might have to pay some additional basis points for the initial low liquidity of this instrument.

Dodd and Spiegel (2004) have suggested ways in which such paper, in a basket developing country currencies, could be created without World Bank or other IFI support. If this was feasible, then the cost to the international community would be zero.

III. Conclusions; costs and benefits of reforming the international financial system

As can be seen from Table 4, and the discussion in the preceding sections, the costs of inaction have been massive, due to extremely large output losses in countries undergoing currency and twin crises. Recent estimates (including our own) range from US\$ 107 billion to US\$ 150 billion annually.

Table 4

Estimated cost of inaction; output losses due to currency and twin crises Annual	Cost of corrective actions	
	Measures	Estimated Annual Costs
US \$ 107 billion – US\$ 150 billion	1. Improved national financial regulation	US\$ 100 million
	2. Capital controls on excessive inflows	0
	3. Issuing SDRs	0
	4. Creating “son/daughter” of CCC	0
	5. Liberalizing CFF for middle-income countries	0
	6. Liberalizing PRGF and subsidizing CFF, for low-income countries	Small
	7. Counter-cyclical guarantees	To be estimated
	8. IFIs borrow and lend in basket developing countries	0 – US\$ 500 million
	9. Similar to 8, but without IFI intervention	0

The costs of actions (reforms of the international financial systems) to provide appropriate provision of the global public good of international financial stability are extremely modest in comparison, as estimated in Table 4. They range from zero for some measures to US\$ 100 million – US\$ 500 million for other.

The estimated net benefit of international financial reforms would therefore reach US\$ 106 billion – US\$ 149 billion.

There are naturally several assumptions behind these calculations (see text above). They also include the assumption that the suggested changes would eliminate crises happening. But even if they did not eliminate them, but reduced their cost by half, the net benefits would be massive.

If the net gains of such reforms are so extremely large, it seems relevant to quote George Bernard Shaw: “You tell me what is, and ask why; I ask what would be, and ask why not?”

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