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International financial system and development

Report of the Secretary-General

Summary

The present report, responding to General Assembly resolution 57/241, highlights recent developments in the international financial system that have special relevance to development. It contains estimates of the mainly negative net transfer of financial resources of groups of developing countries in 2002 and updates developments in the past year in international financial reform. Specific conclusions and recommendations on relevant issues addressed here may be found in the report of the Secretary-General prepared for the high-level dialogue on financing for development (A/58/216).

* A/58/150.

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I. Introduction

1. The General Assembly has been considering in annual debates since its fiftieth session the opportunities and challenges of international financial flows of developing countries. The opportunities have been seen mainly in the contribution such flows could make to the financing of development. The challenges have been seen mainly in the potential for financial instability embodied in some of these very same flows and in ensuring net benefits for the recipient country. At its fifty-seventh session, the Assembly decided in its resolution 57/241 of 20 December 2002 to continue to discuss the international financial system and development and requested that the Secretary-General report to it at its fifty-eighth session on the matters addressed in that resolution.

2. Resolution 57/241 was adopted less than a year after holding of the International Conference on Financing for Development at Monterrey, Mexico, from 18 to 22 March 2002. The main outcome document of the Conference, the Monterrey Consensus,[1] has become a new framework for policy-making on the interrelations of domestic and international finance, trade and development. Indeed, it greatly influenced resolution 57/241, while it covered more issues than were the subject of the resolution. During its current session, the Assembly will hold its first high-level dialogue on financing for development in order to take stock of implementation thus far and to follow up on the commitments and agreements made at Monterrey. A report (A/58/216) was prepared for that dialogue, in close consultation and collaboration with the major institutional stakeholders in the Monterrey process, and it contains a number of specific recommendations that pertain to the concerns of the present report. In order to avoid unnecessary duplication, readers are referred to that report for conclusions and recommendations pertaining to the present report.

3. With this context in mind, the present report updates information on the net foreign transfer of financial resources by developing countries and on major developments in selected policy areas since the previous report (A/57/151) on this subject was prepared.

II. Net transfer of financial resources of developing and transition economies

4. Developing countries made a net transfer of financial resources to other countries in 2002 for a sixth consecutive year, as payments of foreign investment income and net financial outflows, including increases in holdings of foreign reserves, exceeded receipts of foreign investment income and net financial inflows from abroad (see table 1). Indeed, measured in dollars it was the largest negative resource transfer ever by these countries. There was also a net outward transfer of financial resources from economies in transition in 2002.

Table 1
Net transfer of financial resources to developing economies and economies in transition, 1994-2002
(Billions of United States dollars)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*[a]
Developing economies	44.2	49.7	30.3	-2.7	-33.7	-120.9	-179.3	-155.1	-192.5
Africa	4.6	6.6	-4.4	-3.7	15.6	5.1	-18.8	-11.2	-9.0
Sub-Saharan (excluding Nigeria and South Africa)	6.7	8.2	10.5	7.9	13.2	9.7	5.0	9.0	9.5
Eastern and southern Asia	5.1	25.6	22.4	-34.6	-130.1	-134.8	-110.4	-111.0	-141.5
Western Asia	15.2	18.8	11.2	11.4	36.1	-0.3	-48.3	-34.9	-13.2
Latin America and the Caribbean	19.3	-1.3	1.1	24.2	44.7	9.1	-1.8	2.0	-28.8
Economies in transition	-2.2	10.0	20.0	30.2	33.7	4.5	-23.4	-9.7	-9.5
Memorandum item: heavily indebted poor countries	9.6	10.9	10.7	11.2	13.7	10.7	5.7	8.2	10.3

Source: *World Economic and Social Survey 2003*.
[a] Preliminary estimate.

5. A net inward transfer of financial resources can be an important supplement to gross domestic saving to finance domestic investment. Conversely, a net outward transfer of resources means those resources are not available for consumption or investment in the country. The large net outward transfer of financial resources from Latin America and the Caribbean in 2002 had as its counterpart a sharp contraction of imports as crisis countries compressed consumption and investment in response to the withdrawal of capital flows by international investors. On the other hand, in East and South-East Asia, the very large net outward resource transfer grew substantially yet again, but in an environment of strong growth of exports and imports underpinned by economic growth. Financial resources flowed into net repayment of debt and purchase of foreign assets, especially in the form of official reserve accumulation. The net inward transfer of resources to sub-Saharan Africa (excluding Nigeria and South Africa) consisted of net private and official financial flows, which helped to finance the trade deficit.

6. Focusing on the net capital flow component of the net transfer, table 2 shows that developing countries received an estimated $75 billion in net capital inflows in 2002, less than one half the average annual level in the mid-1990s. The only net sources of capital inflows in 2002 were foreign direct investment and official loans and grants, as financial markets and international banks continued to reduce their exposure to developing countries as a whole. A significant part of the official flows were from multilateral and regional development banks and the International Monetary Fund (IMF), sources whose continuing importance was emphasized in resolution 57/241. Net capital flows to transition economies were stable in 2002, consisting of net inflows of foreign direct investment, portfolio credit, equity investment and official flows.[2]

Table 2
Net financial flows to developing economies and economies in transition, 1992-2002

(Billions of United States dollars)

	Average 1992-1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*[a]
Developing economies							
Net private capital flows	149.1	96.6	38.9	66.2	18.2	17.9	51.8
Net direct investment	66.1	120.5	128.0	133.0	125.6	145.3	110.0
Net portfolio investment[b]	63.0	41.6	-3.7	39.0	9.7	-41.7	-40.0
Other net investment[c]	19.9	-65.5	-85.3	-105.8	-117.2	-85.8	-18.2
Net official flows	23.3	40.8	49.3	10.5	-0.7	25.6	22.9
Total net flows	172.4	137.4	88.2	76.7	17.5	43.5	74.7
Economies in transition							
Net private capital flows	19.8	-20.9	14.5	29.8	32.9	20.9	34.1
Net direct investment	8.2	15.5	20.8	23.8	23.4	25.2	29.2
Net portfolio investment[b]	10.5	6.9	5.4	2.4	2.4	3.2	3.4
Other net investment[c]	1.1	-43.3	-11.8	3.6	7.1	-7.4	1.5
Net official flows	-2.6	15.5	33.7	3.5	-3.1	13.2	2.9
Total net flows	**17.2**	**-5.4**	**48.2**	**33.3**	**29.8**	**34.1**	**37.0**

Source: World Economic and Social Survey 2003.

[a] Preliminary.

[b] Including portfolio debt and equity investment.

[c] Including short- and long-term bank lending; owing to data limitations, may include some official flows.

7. Preliminary indications are that some types of private financial flows to developing countries improved in the first half of 2003, in part because certain domestic and international policy measures feared by the international private sector did not materialize, and in part because the sluggish recovery, unusually low interest rates and uncertain profit prospects in the developed countries made international investors more willing to search for higher yield in emerging market economies. If the economic recovery in the developed countries gathers momentum in the second half of the year, as forecast by the Department of Economic and Social Affairs,[3] then it is possible that investors will again reduce their “appetite” for emerging-market lending. Nevertheless, as world trade growth would accelerate with that recovery, earnings prospects in developing and transition as well as developed economies would rise. Potential international investors might thus be encouraged to increase or maintain their flows, at least to those emerging economies found attractive and judged to be pursuing sound macroeconomic and exchange-rate policies.

8. It is clear, however, that developing and transition economies remain as exposed as ever to the vicissitudes of the global economy. Negative net transfers to developing countries in periods of slow growth of the world economy are particularly harmful to development. For example, in Latin America the investment rate (investment as a percentage of gross domestic product) started falling in 1999.

In 2002 it fell further when the net transfer turned sharply negative. Currently, it is considerably lower than it was 5 or 10 years ago. Such a decline has a negative impact on long-term development.

9. A major goal of international financial reform has been to reduce the potential damage that international financial volatility imposes, while fostering the ability of more countries to tap into potential financial resource transfers that with prudent domestic management can increase economic growth and hasten progress towards poverty eradication.

III. Reform of the international financial system

10. In its 2002 discussion of the international financial situation and policy reform, the Assembly addressed a number of issues that can be grouped into three clusters: sound and equitable policies in developed, developing and transition economies; official financial resources adequate to alleviate external financial crises; and processes to strengthen global economic governance.

A. Definition and support of sound policies

11. Developing countries and countries with economies in transition, along with their international partners in global and regional arrangements, have continued to sharpen the definition of sound policies for economic and financial stability, economic growth and sustainable development. Matters addressed have included aspects of domestic governance, macroeconomic policy formulation and policies to develop economic and social infrastructure and the financial sector. Notable steps taken over the past year in this regard involve the New Partnership for Africa's Development;[4] greater international attention to the need for medium-term fiscal frameworks and more effective public expenditure management; greater appreciation of the imperative for prudent fiscal, monetary and exchange-rate management during booms so as to leave more room for counter-cyclical policies during downturns; and better international follow-up to support countries in implementing findings of their financial sector assessment programmes and reviews of financial sector standards and codes. More importantly, together with sharpening the definition of sound policies to foster economic growth, a large number of developing countries and countries with economies in transition have taken concrete steps in several key policy areas, as reflected in the report of the Secretary-General prepared for the high-level dialogue of the General Assembly.

12. In addition, the Bretton Woods institutions have spearheaded new normative analyses and discussions on, for example, how to better assess debt sustainability in low and middle-income countries. At the global level, attention over the past year has focused on the "market integrity" cluster of international standards and codes, the major development being in the area of accounting, where there was movement towards internationally convergent accounting standards, as developed by the International Accounting Standards Board. There has also been an effort to converge on a single set of principles for insolvency regimes and creditor rights, based on the models developed by the World Bank and the United Nations Commission on International Trade Law. Perhaps the most contentious developments have been in the revision of the capital adequacy framework for commercial banks by the Basel

Committee on Banking Supervision, one large member of which announced this year that it would apply the proposed set of global guidelines only to its largest banks. Concerns have also been expressed by financial experts about whether the guidelines would accentuate the cyclical nature of world financial flows and discourage lending to developing and transition economies in particular.[5]

B. Official resources for crisis alleviation

13. Despite the best efforts to prevent financial crises, it is quite possible that they will occasionally occur and entail significant economic shocks. The international community acknowledges that it needs a strong and comprehensive set of instruments to help countries resolve such eventual financial difficulties. Countries that have liberalized their capital accounts and those in which financial flows into and out of the country are unrestrained are particularly vulnerable to sudden reversals of financial flows. One way to reduce the instability of such flows is to raise investor confidence regarding government policy and international support.

14. To increase the clarity and predictability of official responses to crises, IMF adopted a new framework in 2003 for exceptional access to its resources in such capital-account crises. IMF is prepared to provide larger loans than normally allowed if the country involved meets the following criteria: exceptionally large need; a sustainable debt burden under reasonably conservative assumptions; good prospects of regaining access to private capital markets within the time IMF resources would be outstanding; and indications that the country’s policies have a strong chance to succeed.

15. Along with developing a clearer set of guidelines for when to use official resources, IMF has sought to improve its loan facilities to better support countries in capital-account crisis. Most of the Fund’s facilities were designed in a period of low capital mobility to deal with more slowly evolving current-account crises. However, the traditional strategy of enforcing policy conditionality by disbursing funds in tranches over time might not work to stem modern capital-account crises, which move much faster and may generate large swings in capital flows.

16. In response to these new realities, in 1997 IMF established the Supplemental Reserve Facility (SRF). SRF can provide larger and more front-loaded packages to countries hit by capital-account crisis. In March 2003, the IMF Executive Board decided to lengthen the maturity of drawings from SRF by one year, as experience has shown that the duration of balance-of-payments need might require the longer period. At the same time, it decided to retain quota-based access limits to SRF (300 per cent of quota). It has been argued, however, that exceptional access norms should not be linked to country quotas and that it is necessary to examine other approaches.[6]

17. The Contingency Credit Line (CCL), introduced by the Fund in 1999, was intended to go beyond SRF by offering external liquidity with a high degree of automaticity to pre-qualified countries during an emergency. By providing an agreed credit line in advance, CCL was expected to have a preventive function that could help deter a sudden withdrawal of external credit. However, as at June 2003, no member country had availed itself of the facility. Potential users have apparently been concerned that application for the facility, let alone drawing from it, would be viewed as a sign of weakness by the market, thereby reducing rather than

strengthening confidence in the country. The scheduled expiration of the facility is November 2003, and there appears to be insufficient support to extend it.

18. Meanwhile, in May 2002 the World Bank introduced a structural adjustment counterpart to CCL, the deferred drawdown option (DDO), to protect core structural programmes should a country face reduced access to international financial markets. A DDO in effect gives borrowers a credit line on which they can draw for up to three years, provided that overall programme implementation and the macroeconomic framework remain adequate. Several countries have already arranged DDO facilities, as they consider that, unlike CCL, this instrument does not have the negative signalling function.

19. In paragraph 7 of resolution 57/241, the Assembly expressed concern that IMF should have "adequate resources to fulfil its financial responsibilities" and, in paragraph 14, that the Fund and other international financial institutions should "have a suitable array of financial facilities and resources to respond in a timely and appropriate way in accordance with their policies". In paragraph 16 of the resolution the Assembly encouraged the exploration of "innovative sources of finance" and took note of the proposal to use special drawing rights (SDRs) for development purposes. In this regard, an important reform proposal has been made on how and why IMF should allocate SDRs.[7] The argument, in essence, is that SDRs were created for a purpose rendered moot when the original Bretton Woods system collapsed, but that SDR allocations could significantly help developing and transition economies to bolster their official reserves at lower cost than borrowing in the international financial market or following policies that in effect accumulate reserves at the expense of imports, as they have been doing. The authors further argue that SDRs might be allocated to meet such aims without amending the Fund's Articles of Agreement, through a reinterpretation of the governing article, although an amendment would of course make the new intent of the Fund shareholders crystal clear. Prominent authorities in academic and private life, as well as senior officials of Governments and international institutions, have also made proposals for renewing allocations of SDRs, including a call for substantial temporary SDR allocations in times of international financial crisis.[8] These proposals to alter the SDR allocation process have not yet received broad international consideration.

C. The process of international financial reform

20. It is in the "spirit of Monterrey" to entertain new ideas about financing for development, such as those referred to above, and analyse them rigorously and in open debate among the relevant stakeholders. Indeed, this has been happening in various institutional settings since the Monterrey Conference. In particular, while supporters of the IMF proposal in late 2001 for a sovereign debt restructuring mechanism (SDRM) were disappointed that the proposal did not win broad backing, there was an unprecedented amount of open debate on the issue in 2002 and 2003, in which IMF participated, including the debate that it hosted and the one on the fringes of the Monterrey process itself. In the end, a proposal that addresses part of the problem began to be implemented by individual countries, as strengthened "collective action clauses" were added to new bond issues, first by Mexico and then by Brazil, South Africa and Uruguay in 2003. It will be easier to restructure bonds under the new clauses in the event of future crises. Yet this leaves unaddressed the coherence, comparable treatment, debt-restructuring adequacy and equity issues on

which the SDRM proposal had also focused. Those issues may be addressed, albeit not in statutory form, in proposed codes of conduct for debtor Governments, creditors and international organizations that have been offered for consideration by the international community.

21. Since the adoption of the Monterrey Consensus, the consideration of increased participation of developing countries in international economic decision-making has gathered momentum. The Fund and the World Bank, engaged through the Development Committee, took up the issue of raising the voice and enhancing the participation of developing and transition economies in decision-making in the Bretton Woods institutions in the fall 2002 and spring 2003 meetings. The issue is to be discussed further at the fall 2003 Development Committee meeting. The consideration of increased participation of developing countries in economic decision-making also figured prominently in the annual meeting of the Economic and Social Council with the Bretton Woods institutions and the World Trade Organization, as reflected in the Economic and Social Council President's summary of the proceedings (A/58/77-E/2003/62 and Add.1 and 2).

22. The international system has not yet found the optimum process for vetting ideas internationally. Nevertheless, the international community has begun to engage on the issue and is devising new modalities of interaction. This includes using the Monterrey process at the United Nations, in particular when issues of the coherence and consistency of international monetary, financial, trade and development policies are not addressed in all their dimensions by the specialized international forums. The special meeting of the Economic and Social Council with the Bretton Woods institutions and the World Trade Organization on 14 April 2003 was a case in point, and the President of the Council drew conclusions on both process and substance in his summary of the meeting. The high-level dialogue in the Assembly will be another important innovation.

IV. Conclusion

23. **As noted at the outset, the matters highlighted in the present report are among the focuses of the report of the Secretary-General prepared for the high-level dialogue on financing for development. All chapters of that report — in particular its recommendations — are relevant for the consideration of this report in the light of the need for and commitment to a holistic approach to financing for development.**

Notes

[1] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

[2] See *World Economic and Social Survey 2003* (United Nations publication, Sales No. E.03.II.C.1), chap. II, from which this account has been drawn.

[3] Ibid., chap. I.

[4] See A/58/254.

[5] For additional discussion on this and other standards and codes, see *World Economic and Social Survey 2003* (United Nations publication, Sales No. E.03.II.C.1), chap. II.

[6] See, for instance, International Monetary and Financial Committee, statement by Aleksei L. Kudrin, Deputy Prime Minister and Minister of Finance of the Russian Federation, Washington, D.C., 12 April 2003 (http://www.imf.org/external/spring/2003/imfc/state/eng/rus.htm).

[7] See Peter B. Clark and Jacques J. Polak, "International liquidity and the role of the SDR in the international monetary system", IMF working paper WP/02/217 (December 2002), and the interview with the authors in *IMF Survey*, 3 February 2003, pp. 28-30.

[8] See "Towards a new international financial architecture", report of the Executive Committee on Economic and Social Affairs of the United Nations (ECESA/1/Rev.1), 25 June 2001 (available at http://www.un.org/esa/coordination/ecesa/ecesa-1.pdf).