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Report of the Secretary-General**

Summary

The present report, submitted in compliance with General Assembly resolution 58/202, complements the report of the Secretary-General on follow-up to and implementation of the outcome of the International Conference on Financing for Development (A/59/270). It reviews recent developments in the international financial system with particular relevance to developing countries. It contains estimates of the net transfer of financial resources of regional groups of developing countries in 2003 and updates developments in international financial reform since the preparation of the previous report of the Secretary-General (A/58/369). The report highlights: (a) measures taken by developing countries to contribute to a more stable international financial system; (b) the need for the international community to promote policies to reduce developing countries' exposure to international economic and financial developments, given these countries' susceptibility to shocks; (c) the importance of exploring more appropriate regulatory instruments and more flexible debt instruments to better assist developing countries in reducing the volatility of their external payment positions and the vulnerability of their debt structures to crisis; (d) the need for continued work on crisis prevention and resolution; and (e) the need for the international community to continue the search for acceptable political solutions that can lead to broadening and strengthening the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting.

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

1. A net inward transfer of financial resources[1] supplements gross domestic saving and enables countries in the early and middle stages of development to raise investment levels above what could be financed by domestic saving. Yet, developing countries as a group have made increased net outward financial transfers each year since 1997, reducing the amount of domestic saving available to finance development. In 2003, total net transfers from developing countries rose to an estimated $248 billion, surpassing the previous peak in 2002 (see table 1). There was also a net outward financial transfer of $28 billion from countries with economies in transition.

Table 1
Net transfer of financial resources to developing economies and economies in transition, 1995-2003
(Billions of United States dollars)

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003[a]*
Developing economies	43.6	21.2	-3.4	-36.8	-122.8	-183.3	-151.3	-203.5	-247.5
Africa	6.6	-5.0	-4.3	15.9	6.0	-23.9	-11.8	-3.4	-15.8
Sub-Saharan (excluding Nigeria and South Africa)	7.7	5.7	7.6	12.2	9.0	3.2	8.3	6.6	6.6
Eastern and southern Asia	26.2	23.8	-28.7	-130.2	-134.1	-108.2	-107.9	-138.6	-144.6
Western Asia	11.9	0.4	4.7	31.3	-6.6	-51.0	-37.2	-30.3	-36.1
Latin America and the Caribbean	-1.1	2.0	24.8	46.1	11.8	-0.2	5.5	-31.1	-51.1
Economies in transition	3.3	10.7	17.2	16.8	-5.9	-32.6	-20.0	-17.6	-27.8
Memorandum item: heavily indebted poor countries	6.9	7.3	7.8	9.6	10.0	6.5	8.3	8.7	11.0

Source: *World Economic and Social Survey 2004* (United Nations publication, Sales No. E.04.II.C.1).
[a] Preliminary estimate.

2. The large net outward transfer of resources from eastern and southern Asian countries in 2003 was the result of continued strong export growth; complemented by policies to support domestic demand, they combined to produce strong economic growth and high domestic saving rates. In contrast, the net outward transfer of resources from Latin America in 2003 was a result of continued compression of domestic expenditure in adjustment to financial crisis. While export growth strengthened substantially with recovery in global trade and agricultural commodity prices, imports only recovered modestly. Besides making debt repayments, financial outflows were also used to increase official reserve holdings for precautionary purposes.

3. The net transfer of resources from developing to developed countries is also a reflection of overall developments in the balance of payments. Since 1999, a number of developing and transition economies have generated sizeable surpluses in their current accounts, primarily as the result of surpluses in their trade of goods and

services, which in the aggregate amounted to $240 billion in 2003, and rising current transfers ($90 billion). The counterpart to strengthened current-account positions and rising net private capital flows was the accumulation of international reserves on the order of $364 billion in 2003 and net repayments on outstanding debt to both private and official creditors.

4. The unprecedented increase in foreign exchange reserves in 2003, which also continued during the first half of 2004, has been concentrated in a small number of developing countries and transition economies. China accounted for more than 40 per cent of the total, but India, Malaysia, Mexico, the Russian Federation and Turkey also accumulated reserves at high rates, as did Brazil and Venezuela, where reserves were restored to 1997 levels. Argentina also built up new reserves, but they remain at half their 1999 level.[2] The accumulation of reserves is mainly held in low-risk and low-yield government securities of developed countries. They thus represent a net transfer of resources from developing to developed countries, and are a major component of the financing of the increasingly large external account imbalances of some developed countries.

5. The decision by monetary authorities in a number of emerging market economies to intervene heavily in the foreign exchange market in order to avoid an appreciation of their currencies against the United States dollar has also produced increasing reserve positions. This has been particularly evident in China’s defence of the exchange-rate band of the *renminbi* vis-à-vis the United States dollar, but monetary authorities in a number of other countries reacted similarly.[3]

6. The policies of developing countries reflect the decision that the cost of large holdings of foreign reserves in terms of the domestic investment and imports foregone is outweighed by the benefits of a stable exchange rate, high export growth and “self-insurance” against capital account volatility. While these costs might be reduced with more flexible exchange rate policies, in the absence of clear evidence that similar benefits could be attained, most countries have resisted this suggestion.

7. This net transfer of resources from developing to developed countries has coincided with increases in net capital flows to many developing countries and countries with economies in transition in 2003. With respect to the net financial flows component of the net transfer of resources, table 2 shows that developing countries received $93 billion in net financial flows in 2003, a substantial increase from 2002 and the preceding two years. These net flows were boosted by a recovery in private financial flows to the highest level since the Asian financial crisis in 1997, the result mainly of a turnaround in banking flows to developing countries after many years of net outflows.

Table 2
Net financial flows to developing economies and economies in transition, 1993-2003
(Billions of United States dollars)

	Average 1993-1997	1998	1999	2000	2001	2002	2003[a]
Developing economies							
Net private capital flows	163.1	47.2	66.2	30.4	2.7	20.5	92.5
Net direct investment	87.8	130.2	145.7	149.8	164.1	112.8	102.6
Net portfolio investment[b]	68.0	26.4	68.2	9.6	-90.8	-91.7	-75.8
Other net investment[c]	7.3	-109.5	-147.7	-129.1	-70.7	-0.6	65.7
Net official flows	15.9	35.6	6.8	-10.6	32.8	5.3	0.5
Total net flows	179.0	82.8	73.0	19.7	35.5	25.9	93.0
Change in reserves	-78.8	-32.9	-84.8	-93.6	-95.4	-170.3	-324.9
Economies in transition							
Net private capital flows	13.5	30.2	20.4	11.8	17.9	26.5	38.7
Net direct investment	11.2	22.7	25.5	25.2	24.9	26.5	16.7
Net portfolio investment[b]	3.0	12.0	-2.2	-3.4	-4.9	-6.9	-11.7
Other net investment[c]	-0.7	-4.6	-2.9	-9.9	-2.2	6.9	33.7
Net official flows	7.0	11.7	-0.4	-3.8	-7.1	-2.1	-5.9
Total net flows	20.5	41.9	20.0	8.0	10.8	24.4	32.7
Changes in reserves	-12.9	-1.7	-7.9	-23.3	-18.1	-25.7	-39.0

Source: *World Economic and Social Survey 2004* (United Nations publication, Sales No. E.04.II.C.1).
[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.

8. Foreign direct investment (FDI) continues to be the most important source of external financing for developing countries, although net inflows of FDI in 2003 fell to their lowest level since 1996 and roughly 63 per cent below their peak in 2001. This may well reflect a change in FDI trends as the wave of privatization, which had been an important driving factor for FDI in the 1990s, has been levelling off.

9. The fall in FDI was, however, more than compensated by other private flows such as net bond and equity flows, so that total net private capital flows to developing countries showed a considerable increase. According to International Monetary Fund (IMF) data based on balance-of-payments statistics, they amounted to more than $131 billion in 2003, their highest level since 1997.[4]

10. These developments have to be seen against the background of investor diversification of portfolios, the recovery of global growth, the improved prospects for growth and stability in many developing and transition economies and sustained low interest rates that produced an increase in private financial flows to developing countries in 2003. Low interest rates and ample liquidity in developed economies encouraged international investors to search for higher returns in the form of higher-risk financial instruments, including high-yield corporate bonds of developed

countries and the bonds and stocks of emerging markets. At the same time, improving prospects for economic growth and corporate profitability led investors to reduce their required risk premia.

11. The improvement in investor sentiment towards emerging markets was reflected in falling spreads, which by January 2004 had reached an historic low, and lower borrowing costs. In particular, there was a significant tightening of the spread between the yield on emerging market bonds and the benchmark United States Treasury bonds during 2003. Low rates of return in developed countries increased the attractiveness of emerging market assets, and higher risk tolerance of international investors enabled lower-rated borrowers to regain access to international capital markets. Among developing countries, the compression in yield spreads was particularly sharp on bonds of a number of Latin American countries and Turkey, which had been pushed to very high levels early in 2003 by financial crises and geopolitical concerns. For example, by January 2004, the spread on Brazilian bonds had fallen below 500 basis points from more than 2,000 basis points in early 2003. Among the economies in transition, yield spreads on Russian bonds reached historically low levels towards the end of 2003, benefiting from continued strong economic growth, exports and the increase in its sovereign bond rating to investment grade.

12. However, yield spreads on bonds of most emerging market countries widened and access to credit markets became more restricted in the first half of 2004 amid concerns about rising interest rates in the United States, renewed threats of terrorism and political uncertainty in some developing countries. This reversal occurred despite generally improving economic conditions in developing and transition economies and reflects the vulnerability of these countries to changes in the international economic environment.

13. Net official flows continued to decline in 2003 as net flows from the multilateral development and financial institutions fell to negligible levels, despite considerable increases in flows of official development assistance from the member countries of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). Net financial flows to countries with economies in transition continued to increase in 2003, but did so more moderately than in 2002.

II. Reform of the international financial system

14. The major focus of international financial system reform in 2003 was on early identification of debt-related systemic vulnerabilities, strengthening the role of surveillance and enhancement of its pro-growth orientation, and better coordination of multilateral and regional surveillance. Additional incidents of corporate fraud and mismanagement renewed concerns about corporate financial reporting, auditing and governance, especially in developed countries. Along with preventive measures, improving the overall framework for the resolution of capital-account crises in developing countries with significant access to international financial markets has been the core issue of the international policy agenda. The policy emphasis in this area has been to insert more certainty and predictability into the process for resolving crisis situations.

A. IMF surveillance

15. In addition to concentration on traditional macroeconomic policies, IMF surveillance has been expanded to include structural and institutional policies, improvement of the transparency of countries' policies, observance of various standards and codes and assessment of financial sector soundness. As of end-December 2003, more than 100 countries had participated, or had agreed to participate, in a financial sector assessment under the joint Bank-Fund financial sector assessment programme, and 491 reports on standards and codes modules had been completed for 101 countries.

16. Along with expanded surveillance coverage, there have been efforts to increase the transparency of IMF assessments of member countries. In June 2003, the Executive Board agreed that after 1 July 2004 publication of IMF article IV surveillance reports and programme documents, as well as reports on use of Fund resources by member countries, would be presumed rather than voluntary. Also after July 2004, the publication of staff reports related to exceptionally large drawings on Fund resources would become a condition for approval.

17. Nonetheless, considerable work remains to be done on crisis anticipation and prevention. Since developing countries are the only current borrowers from the Fund, surveillance may concentrate on these countries, with emphasis on the policies of the major developed countries that have a greater impact on global conditions. Strengthening the impact of surveillance on developed economy policies will probably continue to be one of the major challenges of efforts to further improve the overall surveillance framework.

18. On the other hand, in some cases, the concentration on implementation monitoring of Fund programmes in borrowing countries has led to inadequate assessments of the overall impact of policies on economic performance and the emergence of serious imbalances. Accordingly, there have been calls to strengthen surveillance in programme countries, particularly in those countries that have had IMF arrangements over an extended period of time, by stepping back from monitoring programme implementation to undertake a fresh and critical assessment of policies from a medium-term perspective.

19. In conducting surveillance exercises, it is often not enough to inform country authorities of problems of policy incompatibility or incoherence. Rather, surveillance should contribute more to helping countries find economically, politically and socially acceptable policy solutions. An example is the focus on improving public expenditure management in the middle-income countries while ignoring the impact of protracted fiscal adjustment on public investment, particularly in infrastructure, and, hence, on medium-term growth prospects. To help minimize inappropriate constraints on public investment, the Fund is now working on fiscal policy and accounting issues related to public investment, with a view to finding ways to ensure that productive public investment is given increased priority and is appropriately protected during periods of fiscal adjustment. To test the new approach to public investment issues, the Fund is carrying out pilot case studies in several countries, including Brazil, Chile, Colombia and Peru. The results of these studies are expected to be discussed by the Executive Board in the first quarter of 2005.[5]

20. In the past, overly optimistic growth projections have often been an important element in the failure to identify vulnerabilities. This calls for more realistic macroeconomic projections and more conservative assessment of sustainable debt levels in the event of adverse circumstances in vulnerability analyses. More generally, Fund surveillance has not always produced early identification of vulnerabilities and induced needed policy changes. In particular, not only the IMF, but also the policy makers in emerging market countries, as well as the financial markets, were slow to recognize the magnitude and the risks associated with the debt build-up in these countries.

21. Better assessment of a country's debt burden and its ability to service that debt is particularly important to both crisis prevention and resolution. The international community has thus sought to strengthen its understanding of debt sustainability and the policies and measures suitable to help borrowing countries service their debt during difficult periods without an unrealistically large contraction in national income and expenditure. In this regard, particular attention is being paid to debt sustainability assessment, balance sheet analysis, liquidity management and financial soundness indicators. These major areas of work to strengthen surveillance are interlinked and centred on improved capacity to address debt problems.

22. In 2002, the IMF introduced a new analytical framework for assessing both fiscal and external debt sustainability in countries with significant access to international financial markets.[6] This framework is now being applied in the context of surveillance with IMF resources. It can also guide debtors and creditors in their discussions on how much debt reduction is required to achieve a manageable repayment schedule.

23. The balance-sheet approach[7] complements traditional analysis of flow variables, such as current account and fiscal balance, by examining stocks and structures of assets and liabilities. According to the Fund, the approach provides a useful analytical framework to detect currency mismatches (a predominance of liabilities denominated in foreign currency over assets denominated in foreign currency) and other balance sheet weaknesses of an economy and its main sectors, which could help strengthen vulnerability analysis and policy advice. Unlike the debt sustainability framework, balance sheet analysis is not yet a regular element of Fund surveillance. As balance sheet analysis is very data-intensive, establishing the necessary database will take much time and effort in many emerging-economy countries. As in the case of the liquidity management framework and financial soundness indicators, the balance sheet approach requires further analytical work. Moreover, given that all these approaches, including the debt sustainability framework, basically target the problem of debt, it is important to assess how they may be incorporated in order to form an integrated view of their implementation.

24. A closely related issue is the proper targeting of surveillance. It is essential that surveillance be tailored to address the circumstances of each country. Over the past several years, surveillance coverage has broadened significantly. However, the policy message given by the surveillance exercise must not be diluted by a standardized approach. In many cases, simplicity and speed might achieve much better results than over complexity and associated slowness of the overall process.

B. Regional cooperation

25. The increased frequency of financial crises in the 1990s has renewed interest in regional monetary cooperation as a means of achieving greater regional financial stability. The most advanced initiative to further monetary and financial cooperation is in East Asia. In May 2000, 10 member States of the Association of South-East Asian Nations (ASEAN) plus three countries (China, Japan and the Republic of Korea) adopted the Chiang Mai Initiative to strengthen regional cooperation through an expanded network of swap facilities among their central banks. The Initiative involves extending the existing ASEAN swap arrangements and establishing a network of bilateral swap arrangements between the ASEAN countries, China, Japan and the Republic of Korea (ASEAN+3). As of May 2004, 16 bilateral swap arrangements out of possible 30, had been concluded with a combined size of $36.5 billion.[8]

26. ASEAN is also engaged in the regional policy dialogue to improve cooperation activities in the areas of surveillance and monitoring, including of capital flows. The surveillance system, put in place in 1999, is basically confined to a semi-annual informal general discussion of the global and regional economic outlook. The efforts currently being made at the institutional level concern the development of early warning systems and monitoring short-term capital flows. There is an understanding that, once the bilateral swap arrangements network is completed, a more formal, rigorous surveillance system may be needed. In May 2004, the ASEAN+3 finance ministers agreed to undertake further review of the Initiative to explore ways of enhancing its effectiveness.

27. Policy discussions are also under way in other developing country regional groupings, including the West African Economic and Monetary Union, the Central African Economic and Monetary Community, the Eastern Caribbean Currency Union and the Maghreb countries associated with the European Union. IMF is increasing its participation in regional surveillance groups and is working towards better coordination of discussions with regional institutions and individual members.

C. Recent developments in the area of international standards and codes, financial regulation and supervision

28. Over the past several years there has been increasing focus on weakness in accounting, auditing and corporate governance in developed countries. In this regard, the eleventh meeting of the Financial Stability Forum, held in Rome on 29 and 30 March 2004, discussed the issues raised by the recent incidents of securities fraud and market abuses, including the Parmalat case, which highlighted the need to further strengthen financial reporting frameworks, as well as the implementation of existing standards. The Forum welcomed the creation, in February 2004, of a special Chairmen’s task force by the International Organization of Securities Commissions Technical Committee to look into these issues. The Forum also underscored the importance of the November 2003 decision of the Council of the International Federation of Accountants to approve, among other governance reforms, the creation of a public interest oversight board to oversee the Federation’s standard-setting activities.

29. These recent incidents also drew attention to the need to improve information exchange, international cooperation and the corresponding regulatory arrangements in dealing with large firms with complex corporate structures operating in multiple jurisdictions. In this connection, the Forum commended the International Accounting Standards Board for its improvements of existing standards and for progress in the convergence of the standards of that Board and United States Financial Accounting Standards Board standards.

30. In March 2004, the European Commission proposed a new directive on statutory audit in the European Union (EU). As in the Sarbanes-Oxley Act in the United States, companies would have to set up independent audit committees with rotating auditors, with all auditors and audit firms undergoing quality assurance reviews. An EU-wide audit regulatory committee and extensive cooperation between member regulators would be established.

31. Primary responsibility for preventing accounting and auditing irregularities in public companies lies with the boards of directors and management of the companies themselves. The Forum has thus considered that the OECD principles of corporate governance, as one of the 12 core sets of standards and codes that it advocates, should be widely adopted. In response to accounting scandals in industrial countries, OECD has recently revised these principles. The revised principles envision strengthening the capacity of companies' shareholders in corporate governance. Also, in cooperation with the World Bank, OECD has established the Global Corporate Governance Forum to promote continuing dialogue on corporate governance.

32. In May 2000, the Financial Stability Forum encouraged offshore financial centres to strengthen their regulatory, supervisory, cooperation and information exchange arrangements and asked IMF to put in place a programme to assess the centres. As of April 2004, 39 of 42 offshore financial centre jurisdictions had been assessed by IMF. According to the Forum, significant reforms have been initiated in most centres in response to its initiative. However, important shortcomings still remain. The momentum for reforms therefore needs to be sustained, which may require additional technical assistance, especially to centres with lower levels of income.

33. In March 2004, the IMF Executive Board reviewed the 12-month pilot programme of anti-money-laundering and combating the financing of terrorism assessments. The Board also endorsed the revised 48 recommendations of the Financial Action Task Force on Money-Laundering as the new standard for such assessments, as well as the revised methodology to assess that standard. The exercise has shown that many low-income countries face challenges in implementing the assessment measures due to insufficient resources and training. Compliance with the eighth newer special recommendations on terrorist financing also remains weak in many countries.

34. As part of its efforts to strengthen measures against the financing of terrorism, the Task Force held a special seminar in February 2004, focusing on the risks posed by alternative money transfer systems, cash couriers and non-profit organizations, as well as on the links between narcotics trafficking and terrorist financing. In the meantime, it announced in February 2004 that it had removed Ukraine and Egypt from its list of non-cooperative countries and territories, due to substantial reforms in the two countries.[9]

35. Meanwhile, the Basel Committee on Banking Supervision has continued work on the New Basel Capital Accord. On 26 June 2004, central bank governors and the heads of bank supervisory authorities in the Group of Ten (G-10) countries met to endorse the new capital adequacy framework entitled "International convergence of capital measurement and capital standards: a revised framework", commonly known as Basel II.[10] The implementation of the New Accord, mainly designed for large, complex and internationally active banking organizations, is scheduled to take effect in the G-10 member countries by year-end 2006. However, the Committee has indicated that a further year of impact studies or parallel calculations will be needed for the most advanced approaches, and therefore these will be available for implementation as of year-end 2007. To that end, work has already begun in a number of developed and emerging market economies on draft rules that would integrate the new Basel capital framework with national capital regimes. However, for many developing countries, moving to the New Accord may not be as important as addressing deficiencies in existing supervisory, capital adequacy and loan-loss provisioning frameworks with appropriate assistance from the international community.[11]

36. The consensus on Basel II does not necessarily indicate that the interests of the developing countries have been fully taken into account, since these countries have no formal representation on the Committee itself. Indeed, some observers have suggested that the new capital framework's heightened sensitivity to risk may reduce foreign lending to developing countries and raise its costs, since exposure to those economies might typically be considered of higher risk. In this regard, it has been suggested that to avoid these negative effects, Basel II should consider the diversification of credit portfolio across both developed and developing markets as an important risk-reducing factor. The Committee has included this issue in its agenda for future work. Another unintended result of the application of the more risk-sensitive New Accord might be an increase in the pro-cyclicality of bank lending, especially to developing countries. In this regard, the architects of Basel II note that supervisory oversight and market discipline should reinforce the incentive for banks to maintain a cushion of capital above the minimum so as to have a margin of protection in downturns. They are also urging financial institutions to adopt risk management practices that take better account of the variations in risk over time and that are not excessively vulnerable to short-term changes. Nevertheless, the regulators' success in dealing with this problem remains a concern for, like traditional prudential financial regulation, Basel II does not fully take into account the macroeconomic context. Hence, in order to prevent excessive risk-taking during boom periods, there may be a need for regulatory instruments that better recognize the connection between macroeconomic cycles and risk-taking by financial institutions.

D. Towards a more stable pattern of external financing

37. One of the major reasons for the persistence of financial troubles in many middle-income countries seems to be the high volatility of their debt service relative to the capacity to pay. Unlike developed countries, most emerging market economies cannot borrow abroad in their own currencies even if they have high-quality policies and strong institutions. Therefore, movements in the exchange rate seriously affect the domestic burden of debt service, and this is a much more

important source of vulnerability than the volatility associated with fluctuations in income. Interest rates on emerging market debt are not only higher than those on developed country debt; they are also subject to large fluctuations when markets change their assessments of the riskiness of a country's debt. This is further affected by domestic interest rate volatility, associated with exchange rate expectations and variations in country risks, as well as by the domestic policies of national monetary authorities.

38. In the past, such changes were the source of sudden and sharp rise in developing countries' debt burdens and a cause of severe external debt difficulties for some countries. Many emerging economies experienced difficulties in meeting external claims at levels of debt indicators equivalent to or even significantly lower than those in many developed countries. This can occur even if a country's macroeconomic policies are sound. Past experience includes several cases where countries previously viewed as having a sustainable debt situation subsequently experienced an external debt crisis.

39. Accordingly, along with further improvement of debt sustainability analysis, the international community is working on ways to help debtor countries better monitor their evolving debt-servicing obligations, particularly to avoid rapid increases in such obligations during external crises. This entails not only prudent debt management, but also reserves policy, prudent use of capital account regulations, access to international liquidity and reducing volatility at the source.

40. Servicing difficulties are often the result of the pro-cyclical nature of official development financing, as well as private flows, as developed countries reduce aid budgets in periods of global slowdown. Measures to improve the counter-cyclical nature of official aid flows and to better coordinate their variations with developing country export earnings would also improve debt sustainability. The latter is of particular importance for the least developed countries.

41. To lower exposure to risk of debt crises, there have been proposals to issue debt instruments whose debt service obligations fluctuate with countries' capacity-to-pay. These have included bonds with coupons indexed to gross domestic product (GDP). There is also some interest in exploring financing arrangements that include guarantee schemes and other mechanisms to reduce the cost of debt during crisis periods. Another proposal calls for international financial institutions to help develop an international market in a basket of inflation-indexed developing country currencies to allow lending in each country's CPI-indexed local currency. According to the proponents of this proposal, with a more complete set of market instruments, developing countries will be in a better position to cope with volatility.

42. Another even more important long-term strategy would foster the development of domestic currency bond markets. The development of these markets has the potential to reduce exposure of emerging economies to maturity and exchange rate mismatches and to risks of sudden loss of access to foreign capital markets. In some cases, enhanced regional cooperation may accelerate the development of bond markets by combining relatively small national markets into a broader regional one. The process of regional bond market integration and development is most advanced in East Asia.

43. In June 2003, the Executives' Meeting of East Asia and Pacific Central Banks Group (EMEAP)[12] launched the Asian Bond Fund 1 (ABF1). The purpose of ABF1

is to diversify a small portion of the Group's United States dollar reserves by investing in securities of Asian sovereign and quasi-sovereign dollar issuers in EMEAP economies (other than Australia, Japan and New Zealand).

44. After the launch of ABF1, the EMEAP members started discussions on ABF2 investing in the participating countries' local currency sovereign and quasi-sovereign bonds. In April 2004, EMEAP announced a preliminary framework for ABF2. EMEAP is aiming to design ABF2 in such a way that will facilitate investment by other public and private sector investors along with central banks.

45. The Asian Bond Fund Initiative represents an important step in strengthening regional financial cooperation in East Asia and in promoting the demand for regionally issued bonds. The development of bond market infrastructure and the synchronization of rules and regulations on cross-border flows are at least equally important. These issues are being addressed through the Asian bond market initiative, a joint project of Asia-Pacific Economic Cooperation and ASEAN+3.

D. The modalities of official liquidity provision

46. The multilateral financial institutions have a long-standing responsibility to provide adequate financial support to assist countries in undertaking appropriate economic adjustments to balance-of-payments problems. Over the past year, the focus has been on trade-related financing, precautionary arrangements that could help prevent capital-account crises in emerging markets and the role of official resources in crisis resolution.

Trade-related financing

47. The sharp contraction in trade financing to the developing countries during recent financial crises has highlighted the need to improve the stability and the security of its sources. Accordingly, the international community is exploring various schemes to support trade finance.

48. The World Trade Organization (WTO) organized a meeting of experts in the area of trade financing in January 2004, as a follow-up to the earlier meeting convened by the IMF in 2003, to discuss ways of improving developing countries' access to trade financing, particularly in periods of financial crisis. It reviewed the effectiveness of credit lines or guarantees supplied by international public agencies in the light of lessons drawn from the Asian financial crisis, when targeted temporary financing proved helpful. The experience since then suggests that an effective strategy could be built around multilateral development banks trade finance facilities, complemented by a more coordinated approach by official export credit agencies. A short-term trade-facilitation "global alliance", involving nearly all regional development banks, is now being established. Recent experience also suggests that multilateral development banks trade finance facilities can be effective in mobilizing additional private sector funding and providing risk pooling opportunities for private and public trade credit providers and insurers. Trade finance not only supplies liquidity necessary for efficient trade, but also enables less creditworthy and poorer countries to access international capital markets at a lower cost.[13]

49. The current round of negotiations under the General Agreement on Trade in Services can be used to make the provision of trade financing more secure and more readily available to developing countries. Indeed, WTO was directed, at its fifth ministerial meeting in Cancún, to contribute to efforts to maintain trade finance during crises.

50. In April 2004, the IMF Executive Board approved the trade integration mechanism (TIM) to assist member countries in meeting short-term balance of payments shortfalls related to the implementation of trade liberalization measures by other countries. Payments difficulties resulting from reforms of a country's own trade regime will continue to be addressed under previously established policies. TIM is not a new lending facility. Rather, it is a policy aimed at making existing instruments more predictably available for supporting trade liberalization. Accordingly, financing terms and the conditionality under TIM will be those of the underlying facility.

51. In March 2004, IMF concluded the review of the Compensatory Financing Facility (CFF) to help cope with temporary export revenue shortfalls caused by exogenous shocks in developing countries' export markets. Established in 1963, the facility has not been used since 1999. For middle-income countries the usefulness of CFF has diminished as a result of increased access to international capital markets and the need to enter into a regular stand-by arrangement to draw on CFF, in contrast to its original design and intention. Although low-income countries have very limited access to capital markets and official bilateral financing may not be flexible enough to deal with temporary shocks, CFF is not attractive to these countries because of its non-concessional nature. IMF is currently considering extending the Poverty Reduction and Growth Facility to cover CFF conditions, rather than subsidizing the rate of charge for standby or CFF resources.

Precautionary financial arrangements

52. Over the past several years, there have been attempts to develop some form of contingent financing that can be mobilized quickly and on a sufficiently large scale to provide financial support for middle-income countries that face potential capital account crisis. The contingent credit line (CCL), introduced by IMF in 1999, was intended to achieve this objective. However, the facility was never used, and it expired in November 2003. The key problem was that application for CCL approval could be viewed by the market as a sign of weakness, thereby reducing, rather than strengthening, confidence in the country. Also, since the Asian crisis, most emerging markets have adopted "self-insurance policies", including increased foreign exchange reserves, more flexible exchange rate management, changes in liability management practices, strengthening domestic financial institutions and implementing international standards and codes. To the extent that these policies reduce the need for external financing, they have reduced the need for recourse to a CCL.

53. Nevertheless, the lack of a facility providing large-scale financial support to middle-income countries is a significant gap in the set of tools available for crisis prevention. IMF is thus exploring other ways to achieve the objectives of CCL. One of the possibilities is to adapt an existing instrument — standby precautionary arrangements that are typically used when balance of payments pressures are more likely to arise in the current account — to the needs of countries facing potential

capital-account shock. It is vital that the Fund have the capacity to respond quickly to financial needs of member countries that have sound policies but are nevertheless challenged by the actions of the globally integrated capital markets. Discussions are under way on the role that precautionary arrangements can play in preventing capital-account crises and on the access required for this insurance to be meaningful.

The role of official financing in crisis resolution

54. A critical component of crisis resolution is having clear parameters for official intervention. To improve clarity and predictability of official response to capital-account crises, IMF has introduced a framework for exceptional access to its resources. The Fund is prepared to provide larger loans than normally allowed if a country meets the following criteria established in 2002: exceptionally large need; a debt burden that will be sustainable under reasonably conservative assumptions; good prospects for regaining access to private capital markets during the period of the IMF loan; and indications that the country's policies have a strong chance of succeeding.

55. In May 2004, the IMF Executive Board assessed the experience with the new framework, which had been applied in the decisions on Argentina and Brazil. It was noted that the framework had helped improve the clarity and the predictability of the Fund's response to the capital-account crisis. Given the limited experience with the framework, it was decided not to change the exceptional access criteria at this point in time.

56. Among those criteria, the central, and most controversial, is the judgement about debt sustainability. Despite progress in debt sustainability analysis, it is very hard to assess the nature of financial difficulties in the middle of a crisis situation. More sophisticated analytical tools notwithstanding, the key test will continue to be the judgements that are made under uncertainty and political pressure. In order to be credible, those judgements should be as consistent as possible in providing signals to markets concerning when the international community's support will be forthcoming and when it will not.

57. As a result of programmes involving exceptional access, Fund credits to the three largest borrowers (Argentina, Brazil and Turkey) now exceed 70 per cent of total credit outstanding.[14] This increased concentration in lending has been accompanied by more prolonged use of official resources by some middle-income countries with access to international capital markets. By the same token, an increase has also occurred in the Fund's share of large borrowers' external debt. For instance, in Argentina, this ratio rose from 17 per cent to over 22 per cent from the end of 2000 to the end of 2001.[15] Some view this as contrary to the concept of catalytic financing and that it may put at risk the preferred creditor status of the Fund. However, as the Argentina experience indicates, it may lead debtor countries to impose larger reductions of debt service obligations to private creditors to be able to fully service the debt with multilateral institutions, which thus maintain their preferred creditor status. This outcome would appear to negate some of the major assumptions regarding "moral hazard" effects of official lending; in any case, it questions the rationality of increasing such financing when countries have an unsustainable debt burden.

E. Sovereign debt restructuring[16]

58. It is recognized that when debt burdens are truly unsustainable the support of the international community should be accompanied by orderly, predictable and effective debt restructuring. Otherwise, committing Fund resources may compromise its credibility, thereby making the whole process of crisis resolution even more, not less, uncertain. Over the past several years, the international community has made efforts to develop a strategy capable of helping insolvent middle-income countries return to long-term debt sustainability and restore access to private financing.

59. In this regard, it has been suggested that the implementation of the Fund's "lending into arrears" framework should be strengthened. Under this policy, the Fund will disburse loans under one of the regular programmes even if the country is in arrears to its private creditors provided that it makes a strong effort to resolve the arrears. However, this requirement is thought by many as not being sufficiently specific. Accordingly, the development of more operational criteria for judging compliance with the good faith requirement, as well as more rigorous assessments using these criteria, are considered very important. Enhanced clarity could better guide the expectations of investors and debtor countries, thereby fostering the process of debt restructuring negotiations.

60. Although progress has been made on several important issues relating to the process of debt restructuring, agreeing on a statutory approach to reaching a speedy and fair agreement with creditors that may help reduce social and economic costs of default will likely continue to be a major challenge. In reaching a consensus on what the process should involve, legal complexities most likely will not be the most difficult issue. Rather, the hardest and most important part of the problem will be to identify appropriate actions and then reach broad agreement on economic and financial policies and strategies that can help dismantle unsustainable debt structures with minimum damage to the country and its people, as well as to the integrity and the efficiency of international credit markets.

F. Enhancing voice and participation of developing countries

61. The Monterrey Consensus stresses the need to broaden and to strengthen the participation of developing countries and countries with economies in transition in international economic decision-making, both in multilateral intergovernmental institutions and ad hoc forums setting global standards. It encourages the Bretton Woods institutions to continue to enhance the effective participation of these countries in their activities.

62. The recent process for appointing the new IMF Managing Director has produced renewed requests for a more democratic and transparent governance of the Bretton Woods institutions. In March 2004, a group of IMF executive directors representing more than 100 countries called for an open and transparent selection process to attract the best candidates, regardless of nationality.

63. As for voice of developing countries in governance of the Bretton Woods institutions in general, a number of measures have been taken recently to enhance capacity in some developing country executive directors' offices and in capitals of these countries, including the creation of additional staff positions within the two

very large African constituencies, to make them more manageable and representative. Also, an analytical trust fund to assist executive directors representing sub-Saharan countries to undertake independent research and analysis on development issues has been proposed.

64. However, progress is lacking in addressing member country representation on the executive boards and in devising a new formula for assigning votes. These issues are complex but critically important for efficient and equitable representation of member States. Although not necessary, it is widely accepted that changes in representation are likely to be addressed only in the context of an agreement to adjust Fund quotas and World Bank capital to allow them to continue to reflect historical relations on the relative size of individual countries in the global economic system. However, neither is currently on the international agenda. As part of continued efforts to build agreement on governance and representation in the Bretton Woods institutions, the Development Committee asked the Bank and the Fund to prepare a report on all aspects of the voice issue, to be discussed by the Committee at the 2004 annual meetings.

III. Conclusions

65. **Developing countries, supported by the international financial institutions, have taken a wide range of measures in recent years to improve information dissemination and strengthen financial regulation and supervision in order to contribute to a more stable international financial system. Nevertheless, they still remain highly vulnerable to global uncertainties and risks.**

66. **In addition to the actions taken by developing countries to lessen their susceptibility to shocks, the international community needs to promote policies and measures to reduce these countries' exposure to external developments. At present, this requires collective action to ensure an orderly unwinding of global imbalances, with multilateral surveillance focusing on global coherence as well as the domestic suitability of the policies of the largest economies. It is also necessary to ensure coherence between policies and measures intended to restore macroeconomic balance in the world economy and those intended to foster long-term growth and development in the developing countries.**

67. **It is also important to continue exploring measures to better assist developing countries in reducing high volatility of their external payment positions and to make their debt structures less vulnerable to crisis. Here, there may be a need for more appropriate regulatory instruments that fully recognize the close connection between macroeconomic cycles and risk-taking by financial institutions. Also, the development of more variable and flexible debt instruments, as well as financial mechanisms and markets that would allow developing countries to borrow abroad in their own currencies, should be encouraged.**

68. **It is essential to continue work on crisis prevention and resolution. In this regard, there is a need for more effective and less burdensome and intrusive surveillance, backed by lending facilities offering emerging markets some form of contingent insurance that can be mobilized quickly and on a sufficiently large scale if a need arises. Also, despite the recent progress on providing**

greater predictability and order to the resolution of sovereign debt, the lack of multilateral sovereign debt workout mechanisms continues to be one of the major gaps in the international financial architecture.

69. **There is broad recognition that international financial governance structures have to evolve in order to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting. However, the political will to comprehensively address this extremely important issue is still lacking. The international community should continue the search for acceptable political solutions that can point the way towards a breakthrough in this area.**

Notes

[1] The net financial transfer statistic adds together receipts of foreign investment income and financial inflows from abroad minus payments of foreign investment income and financial outflows, including increases in foreign reserve holdings. The net financial transfer of a country is thus the financial counterpart to the balance of trade in goods and services. A trade surplus is generated when the total value of domestic production exceeds domestic consumption and investment, with the excess invested abroad instead of being used domestically and vice versa for a trade deficit.

[2] World Bank, *Global Development Finance 2004*, vol. 1 (Washington, D.C., 2004), table B.41.

[3] United Nations Conference on Trade and Development, *Trade and Development Report 2004* (United Nations publication, Sales No. E.04.II.D.29), chap. II.

[4] IMF, *World Economic Outlook* (Washington, D.C., April 2004), table 2.1.

[5] Remarks by the Managing Director of IMF at the Third Regional Conference on Central America, San Pedro Sula, Honduras, 9 July 2004 (www.imf.org).

[6] IMF, "Assessing sustainability" (Washington, D.C., 28 May 2002).

[7] See Mark Allen, Christoph Rosenberg, Christian Keller, Brad Setser and Nouriel Roubini, "A balance sheet approach to financial crisis", IMF document WP/02/210, and "Integrating the balance sheet approach into fund operations", IMF, 23 February 2004 (http://www.imf.org/external/np/pdr/bal/2004/eng/022304.htm).

[8] See the joint ministerial statement of the ASEAN+3 finance ministers meeting, 15 May 2004, Jeju, Republic of Korea (www.aseansec.org).

[9] The list of non-cooperative countries and territories still includes Cook Islands, Guatemala, Indonesia, Myanmar, Nauru and the Philippines.

[10] Basel Committee Publications No. 107, June 2004 (www.bis.org/publ/bcbs107.htm).

[11] For a discussion of issues related to the implementation of the New Accord in developing countries, see "Guidance for Fund staff", IMF staff note on Basel II, 23 April 2004 (www.imf.org).

[12] Australia, China, Hong Kong Special Administrative Region of China, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Republic of Korea, Singapore and Thailand.

[13] Trade finance spreads averaged 28 basis points lower than spreads on other bank loans over 1996-2002 for a sample of countries with data on comparable transactions; see World Bank, *Global Development Finance 2004.*

[14] In 1980, in contrast, 16 debtors accounted for 70 per cent of credit outstanding; see report of the Acting Managing Director to the International Monetary and Financial Committee (IMFC) on the IMF policy agenda, 19 April 2004 (www.imf.org).

[15] Guillermo Nielsen, "An update on Argentina", Latin American Investor Conference, Merrill Lynch, 27 March 2004 (www.emta.org).

[16] For more details on sovereign debt-restructuring mechanisms, see A/59/219.