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## International financial system and development

### Report of the Secretary-General

*Summary*

The present report, submitted in compliance with General Assembly resolution 59/222, 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/60/___). It assesses the efficiency of the international financial system in allocating financial resources in a way that supports the mobilization of domestic resources and reviews recent measures to improve the stability of the international financial system with particular relevance to developing countries. It reviews policies to counter pro-cyclicality of international capital flows, improve multilateral surveillance, create additional emergency official financing arrangements, strengthen International Monetary Fund financing of poor countries, streamline the conditionality of the Fund's lending, implement sovereign debt restructuring, improve the role of Special Drawing Rights in the international financial system, support South-South cooperation in the international monetary system, and enhance the voice and participation of developing countries in international financial decision-making.

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

1. One of the functions of the international financial system is to allocate resources to their most productive uses. This process is normally considered to produce a positive international net transfer of financial resources[1] in the form of lending by developed countries to the developing world that finances the net import of developed country goods and services. This is in part the result of developed countries' limited investment opportunities due to declining working-age populations and high capital-labor ratios compared to developing countries' young, rapidly growing populations facing a scarcity of capital for their employment. In such conditions the returns to investment in developing countries are presumed to be higher than in developed countries and provide savers in the developed world the possibility to earn higher returns and enjoy increased diversification, while developing countries have access to the financial resources necessary to make capital investments needed to promote growth and higher living standards.

## A. Net resource outflows from developing countries continued in 2004

2. International financial flows in the recent past have, however, departed from this pattern and increasing numbers of developing countries are making net transfers of financial resources to developed countries. These net outward transfers have been increasing steadily since 1997 and reached an estimated $350 billion in 2004 (see table 1). While many developed economies, such as Japan and the European Union, do follow this pattern as reflected in their current account surpluses and net outward financial transfers, this has been more than offset by the inward flow of financial resources required to finance the rising deficits in the balance of payments of the United States of America (see table 1). The result is a reversal of the expected global pattern of financial flows and a net outflow of financial resources from developing countries overall.

3. The counterpart of this net outflow of resources can be seen in the increasingly widespread improvement in the net export balances of developing and transition economies produced by increases in export volumes, as well as increasing prices of commodity exports. Declining debt service due to the recent experience of low international interest rates has converted the improvement in trade balances into positive current account balances for many countries. While the major part of the improvement was concentrated in East and South Asia, net outward financial transfers from Latin America also increased in 2004.

Table 1
**Net transfer of financial resources to selected developed economies, developing economies and economies in transition, 1993-2004**

(Billions of United States dollars)

| | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* | *2002* | *2003* | *2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Developed economies[a] | -65.4 | -44.2 | -41.4 | -4.6 | -33.2 | 5.4 | 146.9 | 305.6 | 283.0 | 277.4 | 327.6 | 639.0 |
| United States | 83.7 | 113.4 | 112.2 | 120.9 | 126.7 | 185.0 | 286.7 | 403.6 | 389.3 | 450.3 | 527.6 | 651.7 |
| Japan[b] | -95.5 | -95.4 | -73.8 | -18.8 | -44.9 | -70.6 | -66.7 | -67.3 | -25.4 | -50.0 | -71.8 | n.a. |
| France | -21.8 | -24.7 | -28.6 | -31.2 | -49.3 | -48.0 | -40.7 | -21.1 | -33.5 | -31.4 | -26.2 | -12.6 |
| Germany | 0.8 | -0.1 | -5.3 | -12.8 | -17.9 | -21.4 | -8.5 | 0.4 | -32.3 | -82.1 | -97.4 | n.a. |
| Italy | -32.5 | -37.3 | -45.9 | -62.7 | -47.8 | -39.6 | -24.0 | -9.9 | -15.1 | -9.4 | -4.6 | n.a. |
| Developing economies | 69.3 | 35.8 | 42.9 | 19.9 | -5.2 | -37.9 | -127.4 | -186.5 | -153.7 | -205.5 | -274.8 | -353.8 |
| Africa | 1.1 | 4.0 | 6.4 | -5.8 | -4.7 | 15.6 | 4.3 | -26.2 | -14.7 | -5.6 | -20.2 | -32.8 |
| Sub-Saharan (excluding Nigeria and South Africa) | 8.6 | 6.7 | 7.4 | 5.3 | 7.5 | 12.1 | 9.1 | 3.0 | 7.9 | 6.4 | 6.5 | 3.9 |
| Eastern and Southern Asia | 18.7 | 1.0 | 22.1 | 18.5 | -31.1 | -128.2 | -142.7 | -121.3 | -113.1 | -142.1 | -147.5 | -167.8 |
| Western Asia | 33.1 | 13.2 | 15.6 | 5.3 | 6.2 | 28.5 | -0.9 | -39.1 | -32.0 | -26.7 | -47.6 | -79.9 |
| Latin America | 16.4 | 17.7 | -1.2 | 1.8 | 24.5 | 46.2 | 11.8 | 0.1 | 6.1 | -31.1 | -59.5 | -73.4 |
| Economies in transition | 1.8 | -3.9 | -2.3 | -6.2 | 2.7 | 3.0 | -24.0 | -48.8 | -30.5 | -27.0 | -34.4 | -57.6 |
| Memorandum item: Heavily indebted poor countries | 8.5 | 7.1 | 6.3 | 6.8 | 7.1 | 8.6 | 10.1 | 8.8 | 8.8 | 9.9 | 10.6 | 11.3 |

*Source*: Department of Economic and Social Affairs, based on International Monetary Fund (IMF), *World Economic Outlook* (April 2005) and IMF balance of payments statistics.

[a] Figures are total net transfers of the five developed economies listed.

[b] No data on workers' remittances from 1993-1995 for Japan.

## B. Net private flows to developing countries improved in 2004

4. Continued improvement in trade performance and macroeconomic conditions, combined with more optimistic investor sentiment and supported by a favourable international financial environment, produced a two-fold increase in net private capital inflows to developing and transition economies compared to the level in 2003 (see table 2). There were substantial increases in foreign direct investment and portfolio investment flows, to the highest level since the Asian financial crisis in 1997. This augmented access to private capital markets allowed many countries to reduce their indebtedness to official sources (see para. 11 below) and to increase their official reserve positions (see para. 13 below).

5. The improvement in net private flows reflects an increasing incidence of credit rating upgrades of emerging market sovereign debt issuers, resulting in a new high in average credit quality and an increasing percentage of emerging market sovereign bonds with an investment-grade rating. This improvement in credit ratings and the inclusion of emerging market bonds in global bond indices has led to a broadening of the investor base to include institutional investors.

6. Divergence in regional private financial flows continued in 2004 and has resulted in changes in regional distribution of these flows. The most striking is the strong increase in flows to East and South Asia, particularly China, at the expense of Latin America. Consequently, while private financial flows to this Asian subregion have recovered strongly since the end of the 1990s, financial flows to Latin America have dwindled from a high in 1997.

7. Foreign direct investment continued to be the largest source of external financing for developing countries and economies in transition. There was a broad-based recovery in foreign direct investment to these countries in 2004 after two years of retrenchment. A combination of factors, including improvement in investment climate, strong commodity prices and the global economic recovery, provided impetus for increased investment by transnational corporations. Growing opportunities for mergers and acquisitions also bolstered investment.

8. Net portfolio flows to developing and transition economies also rose substantially in 2004 and continued early in 2005 until a retrenchment in the second quarter of the year, in response to deterioration in investor sentiment. Net bond issuance was strong across developing regions, particularly in East and South Asia, and to a lesser extent Latin America and Western Asia. Many issuers of sovereign bonds were able to meet a substantial portion of their annual financing needs early in 2005 and to extend maturities of the bonds issued. In addition, more corporations and lower-rated sovereign borrowers could obtain financing. The sell-off in international credit markets in March-April 2005 led to the postponement or cancellation of some new bond issues but borrowers with high credit ratings had little trouble accessing financing. Issuance of local currency bonds also increased substantially in 2004, although these bonds remain a small proportion of total emerging market bonds.

Table 2
**Net financial flows to developing countries and economies in transition, 1993-2004**

(Billions of United States dollars)

| | *Annual average* | | | |
|---|---|---|---|---|
| | *1993-1997* | *1998-2002* | *2003* | *2004* |
| **Developing countries** | | | | |
| Net private capital flows | 151.5 | 48.3 | 92.1 | 152.3 |
| Net direct investment | 87.7 | 141.1 | 132.8 | 158.3 |
| Net portfolio investment[a] | 65.0 | -8.5 | -9.7 | 13.1 |
| Other net investment[b] | -1.2 | -84.3 | -31.0 | -19.1 |
| Net official flows | 12.3 | 9.3 | -51.4 | -55.9 |
| Total net flows | 163.8 | 57.6 | 40.7 | 96.4 |
| Change in reserves | -79.3 | -97.9 | -328.2 | -454.9 |
| **Africa** | | | | |
| Net private capital flows | 6.0 | 8.9 | 12.7 | 9.0 |
| Net direct investment | 3.9 | 13.0 | 15.3 | 15.5 |
| Net portfolio investment[a] | 4.0 | 0.2 | -0.6 | 2.9 |
| Other net investment[b] | -1.9 | -4.3 | -2.0 | -9.4 |
| Net official flows | 1.2 | 0.7 | 1.8 | -1.2 |
| Total net flows | 7.2 | 9.6 | 14.5 | 7.8 |
| Change in reserves | -7.2 | -7.2 | -22.9 | -38.7 |
| **Eastern and Southern Asia** | | | | |
| Net private capital flows | 73.4 | -1.4 | 60.0 | 133.0 |
| Net direct investment | 48.1 | 60.5 | 72.3 | 88.6 |
| Net portfolio investment[a] | 21.7 | -6.8 | 2.5 | 25.8 |
| Other net investment[b] | 3.7 | -55.1 | -14.9 | 18.5 |
| Net official flows | 4.2 | 1.9 | -14.3 | 7.0 |
| Total net flows | 77.6 | 0.5 | 45.6 | 140.0 |
| Change in reserves | -44.2 | -93.1 | -238.7 | -356.0 |
| **West Asia** | | | | |
| Net private capital flows | 12.4 | 4.6 | 4.3 | -2.3 |
| Net direct investment | 5.0 | 5.2 | 10.4 | 8.8 |
| Net portfolio investment[a] | -1.0 | -2.4 | -1.5 | -1.4 |
| Other net investment[b] | 8.5 | 1.9 | -4.6 | -9.7 |
| Net official flows | 4.3 | -5.5 | -47.6 | -54.5 |
| Total net flows | 16.7 | -0.9 | -43.3 | -56.8 |
| Change in reserves | -9.0 | -1.5 | -30.8 | -38.2 |
| **Latin America and the Caribbean** | | | | |
| Net private capital flows | 59.6 | 36.2 | 15.2 | 12.7 |
| Net direct investment | 30.8 | 62.5 | 34.7 | 45.4 |

| | Annual average | | | |
|---|---|---|---|---|
| | *1993-1997* | *1998-2002* | *2003* | *2004* |
| Net portfolio investment[a] | 40.3 | 0.5 | -10.1 | -14.2 |
| Other net investment[b] | -11.5 | -26.7 | -9.5 | -18.5 |
| Net official flows | 2.7 | 12.2 | 8.7 | -7.3 |
| Total net flows | 62.3 | 48.5 | 23.9 | 5.4 |
| Change in reserves | -19.0 | 3.9 | -35.8 | -21.9 |
| **Economies in transition** | | | | |
| Net private capital flows | 8.5 | 1.0 | 27.4 | 13.5 |
| Net direct investment | 4.4 | 7.6 | 10.0 | 13.5 |
| Net portfolio investment[a] | -0.2 | -3.3 | -3.4 | -1.4 |
| Other net investment[b] | 4.3 | -3.4 | 20.8 | 1.5 |
| Net official flows | 7.2 | -0.3 | -4.8 | 0.0 |
| Total net flows | 15.8 | 0.6 | 22.6 | 13.5 |
| Change in reserves | -4.9 | -9.0 | -36.9 | -57.1 |

*Source*: *World Economic and Social Survey, 2005* (United Nations publication, Sales No. E.05.II.C.1).

[a] Including portfolio debt and equity investment.

[b] Including short-and long-term bank lending, and possibly including some official flows to data limitations.

9. The increase in equity issuance in 2004 and early 2005 was dominated by activity in East and South Asia. Equity issuance in Latin America, in contrast, remained at subdued levels. As in the case of the emerging market bonds, portfolio equities retrenched in the second quarter of 2005.

10. There was a smaller net outflow of other private investment from developing countries as a whole in 2004 as a result of increased international bank lending and reduced deposits by developing countries in international banks. There were significant regional differences, however, with continued net outflow from Latin America and Western Asia but net inflow to East and South Asia.

11. The net outflow of official financing from developing countries continued in 2004 as loan repayment to multilateral development and financial institutions outpaced loan disbursements. The International Bank for Reconstruction and Development has experienced net inflows since the beginning of the 1990s and since 2002 the Asian Development Bank, the European Bank for Reconstruction and Development and the Inter-American Development Bank have all received net inflows (see table 3). Net official flows to all developing countries were negative for the second consecutive year in 2004. Only the Eastern and Southern Asia region experienced positive flows in 2004 (see table 2). This reflects the fact that the multilateral financial institutions are no longer providing net financial resources to developing countries, but are currently net recipients of financial resources.

Table 3

**Selected multilateral financial institutions: net transfers of resources, 1990-2004[a]**

(Millions of United States dollars)

| | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* | *2002* | *2003* | *2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| African Development Bank | 645.3 | 557.3 | 519.7 | 544.9 | 542.2 | 518.3 | 404.6 | 235.3 | 388.9 | 510.4 | 358.4 | 819.7 |
| Asian Development Bank | 931.4 | 1 100.8 | 793.8 | 33.6 | 3 753.9 | 4 232.6 | 1 719.0 | 3.7 | 464.3 | -1 379.9 | -5 321.1 | -2 019.2 |
| Inter-American Development Bank | -357.0 | -1 437.0 | -474.0 | -439.0 | 720.0 | 2 157.0 | 3 364.0 | 1 255.0 | 925.0 | -1 292.0 | -1 509.0 | -3 913.0 |
| European Bank for Reconstruction and Development | | | 761.1 | 823.8 | 1 032.9 | 1 146.0 | -159.4 | -183.4 | 359.9 | -395.4 | -569.8 | -565.1 |
| World Bank | -1 177.0 | -3 134.0 | -2 607.0 | -917.0 | 1 926.0 | 1 551.0 | 921.0 | -386.0 | -540.0 | -7 296.0 | -6 992.0 | -6 075.0 |
| International Bank for Reconstruction and Development | -5 246.0 | -8 309.0 | -7 033.0 | -6 131.0 | -2 834.0 | -2 723.0 | -3 019.0 | -4 079.0 | -4 970.0 | -12 126.0 | -11 350.0 | -10 084.0 |
| International Development Association | 4 069.0 | 5 175.0 | 4 426.0 | 5 214.0 | 4 760.0 | 4 274.0 | 3 940.0 | 3 693.0 | 4 430.0 | 4 830.0 | 4 358.0 | 4 009.0 |
| **Total** | **42.7** | **-2 912.9** | **-1 006.4** | **46.2** | **7 975.0** | **9 604.9** | **6 249.2** | **924.6** | **1 598.1** | **-9 852.9** | **-14 033.5** | **-11 824.6** |

*Source*: Annual reports of the multilateral financial institutions, various issues; The World Bank, *Global Development Finance*, various issues.

[a] Net transfers are defined as loan disbursements less principal repayments/prepayments and interest/charges received.

## C. The impact on developing countries of net resource outflows

12. The improvement in net private flows, while substantial, was not sufficient to offset the net outflows due to debt service payments, the rising trade surpluses and negative official flows. The net outward resource transfer from developing to developed countries is usually considered to have a negative impact on domestic growth since the net export of goods and services reduces the resources available for domestic consumption and investment.

13. The rising trade surpluses and increasing net private capital flows to developing countries overall led to a record increase in international reserves of $455 billion in 2004, surpassing the $325 billion increase in 2003. East and South Asia accounted for almost 80 per cent of the increase in reserves. These reserves are mainly held in low-risk and low-yield government securities of developed countries, particularly of the United States of America. It is not clear that the returns on these assets are higher than could be achieved from domestic investment, and in many cases they have a negative return. This occurs when the foreign earnings and capital inflows are sterilized through the issue of domestic bonds that have higher rates of interest than received on the investment of the foreign currency reserves.

14. The decision by some Governments of emerging market economies to stabilize the value of their currencies against the United States dollar is one factor accounting for the record accumulation of international reserves. Another is the perceived need, in the aftermath of the increasingly virulent financial crises of the late 1990s, to protect domestic activity levels from international financial instability. From the perspective of developing countries these policies suggest that the costs of these reserve holdings in terms of foregone domestic investment and imports are more than offset by the benefits of the high export growth resulting from maintaining competitive exchange rates and the cushion provided against volatility of international capital flows.

15. However, the "self insurance" provided by large reserve accumulation could be provided more efficiently by international or regional cooperation in the pooling of resources and multilateral measures to avoid excessively large exchange rate swings. Indeed, one of the original aims of the International Monetary Fund (IMF) was to provide exchange stability through the pooling of member reserves. The persistence of net outflows of financial resources from developing countries along with the continued build-up of reserves suggests that measures should be sought to improve the efficiency of the international financial system and improve the allocation of resources to support development.

# II. Strengthening the international financial architecture

16. Prevention and management of financial crises are crucial to ensuring the development benefits of international capital market allocation of financial resources and reducing the incentives for developing countries to hold large reserve balances. Since the Asian crisis, increased attention has been given to the design of measures at the national and international levels aimed at better managing and preventing financial crises.

## A. Policies to counter pro-cyclicality of international capital flows

17. One of the major reasons for the financial instability of many middle-income countries is the high volatility of external financial flows. One way of addressing this problem may be for public institutions, including multilateral development banks and export credit agencies, to introduce explicit counter-cyclical elements in the risk evaluations they make for the purpose of issuing guarantees for lending to developing countries. When banks and other private lenders lower their exposure, the public institutions would increase their level of guarantees if the country's long-term fundamentals remained basically sound. When private banks' willingness to lend returned, multilateral development banks or export credit agencies could reduce their exposure.

18. There is also scope for cushioning of emerging market borrowers against adverse economic developments by linking debt payments more directly to the borrower's ability to pay. Some countries have experimented with bonds whose coupon and/or principal payments are linked to the price of their major export commodity and bonds linked to gross domestic product have been issued. Such bonds would allow countries to insure against a broader set of risks and are likely to be more useful for those developing countries with diversified production and exports.

19. The risks faced by developing countries over the business cycle could be better managed through development of domestic capital markets, especially local currency bond markets. Such bond issues would eliminate the currency mismatches that have been a prominent feature of almost every major emerging-market financial crisis of the past decade. Local currency bond markets have expanded rapidly in many Asian and some Latin American economies. For emerging markets as a whole, nearly 90 per cent of the increase in debt securities now reflects domestic issuance and at the end of 2002, domestic bonds accounted for around 80 per cent of total outstanding emerging-market bonded debt. Lending by foreign banks has also shifted from largely dollar-denominated cross-border loans to local currency loans through local affiliates.

20. Given the evidence that capital account liberalization increases macroeconomic volatility, many developing countries have experimented with capital controls. The evidence shows that there has been a slowdown in the removal of capital controls in developing countries since 1998. Capital account regulations could play a role in providing room for counter-cyclical monetary policies that smooth debt ratios and spending and in improving external debt profiles.

21. With the advent of liberalization, both national and international capital markets have tended to become more pro-cyclical, increasing the likelihood of boom-bust cycles. Improving the safeguards against instability calls for a modified approach to prudential regulation with a system-wide perspective.[2] The importance of a macroprudential perspective as a complement to the more traditional microprudential focus is widely recognized. Its objective is to limit the risk of episodes of financial distress with significant losses in terms of real output for the economy as a whole. Consequently, it stresses the need to establish larger margins of safety as financial imbalances build up during the upswing in order both to restrain excesses and to give more scope to support losses in the downturn. This implies introducing some counter-cyclicality into financial regulation that would

compensate for the tendency of financial markets to behave in a pro-cyclical manner.

22. This regulatory approach will be seriously tested for the first time during and after the implementation of the New Basel Capital Accord, which, according to many observers, will increase pro-cyclicality of bank lending especially to developing countries because of its increased risk-sensitivity. To alleviate these concerns, the architects of the New Accord note that supervisory oversight and market discipline should reinforce the incentive for banks to maintain a reserve cushion 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 evolution of risk over time (thus taking better account of the full business cycle) and that are not excessively vulnerable to short-term revisions. It has also been argued that because of the greater disclosure built into Pillar 3 of the New Accord, markets may become less tolerant and more suspicious of risk assessments that are too volatile and lead to substantial upgrades in good times. Nevertheless, the regulators' success in dealing with the problem of pro-cyclicality of the New Accord remains an issue of serious concern.

## B. Multilateral surveillance

23. Surveillance of national macroeconomic and, since the Asian crisis, financial policies remains at the centre of crisis prevention efforts. It has been argued, however, that the increasing complexity of financial markets may have rendered the existing instruments of surveillance such as article IV consultations, financial sector stability assessments and programmes, and reviews of the observance of international codes and standards less effective than assumed in identifying and preventing crises.

24. The latest review by IMF of its surveillance activities concluded that they should focus on improving analytical tools for early identification of vulnerabilities, including more rigorous assessments of balance sheet weaknesses and stress testing the impact of possible macroeconomic shocks. To make surveillance more effective, increased focus on country-specific areas of vulnerability is considered necessary. That requires surveillance that is tailor-made to address those macroeconomic issues that are relevant in each member country.

25. In addition, there is a need to better understand the constraints on a country's ability to adopt recommended policies. An appreciation of institutional, social and political realities must underlie policy advice. Also, insufficient attention has been given to ways of improving the scope for countries to adopt counter-cyclical macroeconomic policies in the face of trade and, particularly, capital account shocks. A more explicit focus on ways to enhance such room for manoeuvre would constitute a major advance towards more effective crisis prevention efforts and International Monetary Fund financial support.

26. The publication of article IV surveillance reports and programme documents as a means of increasing the transparency of surveillance is now taken for granted. Increased transparency is thought to help improve both countries' policies and the quality of the Fund's work. However, greater transparency may impede the Fund's role as a provider of candid and frank advice. Hence, in handling sensitive topics

during surveillance exercises, there is a need for an appropriate balance between candour and confidentiality.

27. The Fund's ability to influence policies through surveillance is most limited with regard to large non-borrowing, mostly developed countries. At the same time, these countries have the greatest global impact. Consequently, the role of IMF in macroeconomic surveillance of major economies and as an honest broker in policy coordination among these countries deserves special attention. Despite the problems of representation, IMF is the only institution where developing countries have a voice in assessing the macroeconomic imbalances of major economies and could eventually have a voice on global macroeconomic policy consistency.

28. There is thus a need to reinforce the role of the Fund in the management of the international monetary system to allow it to be more active in supporting the management of the world economy rather than being confined to the provision of occasional lending to middle-income countries hit by financial crises and balance-of-payments financing for low-income countries.

## C. International official emergency financing and precautionary financial arrangements

29. Enhanced provision of emergency financing at the international level in response to external shocks is essential to lower unnecessary burdens of adjustment and the costs of large reserve balances. Appropriate facilities should include liquidity provision to cover fluctuations in export earnings, particularly those caused by unstable commodity prices, sudden stops in external financing and, as recently emphasized, natural disasters.

30. The evidence of the adverse effects of terms of trade shocks on economic growth is strong. Particularly important is the finding that their effects on growth and poverty reduction can be very large. However, the major IMF facility to compensate for terms of trade shocks, the Compensatory Financing Facility, has become increasingly ineffective. Since its modification early in 2000, which basically tightened conditionality for access, the Facility has not been used in spite of the additional shocks affecting developing countries.

31. During the 1990s, capital account liberalization and high capital account volatility greatly increased the need for official liquidity to deal with sudden and large reversals of flows. There is an increasing consensus that many of the recent crises in emerging markets have been triggered by self-fulfilling liquidity runs rather than fundamental disequilibria or incorrect policies. Indeed, capital outflows can be provoked by many factors not related to countries' policies. Among those factors are changes in financial conditions in industrial countries, the pro-cyclical behaviour of capital markets and contagion effects.

32. The enhanced provision of emergency financing in the face of capital account crises is important not only to manage crises when they occur, but also to prevent such crises and to avoid contagion. Indeed, lending of last resort at the national level is essentially conceived as a tool for crisis prevention, particularly to avoid systemic crises.

33. To address this obvious need, IMF has made efforts in recent years to improve its lending policy during capital account crises. The Supplementary Reserve

Facility, established in 1997, provides larger and more front-loaded financing to countries hit by a capital-account crisis, at a higher interest rate, than other Fund facilities. Also, in some cases the Fund has softened its requirements and accelerated approval for the renewal of credits extended under this facility, as occurred with Brazil in 2003 and 2004.

34. However, actions of this nature in favour of some large emerging economies have led to criticism by some IMF members of exceptional access being granted to Fund resources in the absence of an agreement on the conditions that determine eligibility for such special treatment. In February 2003, the IMF Executive Board approved a new framework on exceptional access in a capital account crisis, which includes the following criteria for eligibility: exceptionally large need; a debt burden that will be sustainable under reasonably conservative assumptions; good prospects of 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.

35. A major problem of many recent Fund-supported programmes, especially in cases of capital account crisis, has been the lower than expected levels of private financing, resulting in sharper and more abrupt current account adjustment and steep output declines. Past experience has shown that the catalytic effects of IMF financing on private capital flows works only in rather rare situations when there is no doubt about debt and exchange rate sustainability. This means that a further analysis of the optimal mix between financing and adjustment, as well as the catalytic effects of Fund-supported programmes, is required.

36. The evidence that even countries with good macroeconomic fundamentals may be subject to sudden halts in external financing also gave broad support to the idea that a precautionary financial arrangement, closer to the “lending of last resort” functions of central banks, should be created. The goal would be to establish a mechanism capable of delivering a “pre-emptive strike” to prevent self-fulfilling liquidity crises.

37. The first instrument created for this purpose, the Contingent Credit Line, was never used and was discontinued in November 2003. IMF is now exploring the possibility of adopting stand-by arrangements that are typically used to counter balance-of-payments pressures in the current account to the needs of countries facing potential capital account shock, including the possibility of exceptional access. However, such precautionary arrangements with exceptional access could increase the risk of moral hazard.

## D. Strengthening IMF financing of poor countries

38. In September 1999, IMF transformed the Enhanced Structural Adjustment Facility into the Poverty Reduction and Growth Facility (PRGF) for lending operations in its poorest member countries. PRGF-supported programmes are framed around Poverty Reduction Strategy Papers, the major policy instrument for concessional lending from both IMF and the World Bank, as well as for debt relief under the Heavily Indebted Poor Countries Initiative. In the case of IMF, PRGF-supported programmes are designed to cover mainly areas within the primary responsibility of the Fund, such as exchange rate and tax policy, fiscal management, budget execution, fiscal transparency and tax and customs administration. As of March 2005, 78 low-income countries were eligible for PRGF assistance. At the end

of February 2005, total loan resources provided by PRGF creditors amounted to SDR 15.8 billion, of which SDR 13.3 billion had already been committed and SDR 11.7 billion disbursed.

39. A major issue under debate is how to improve existing arrangements to help low-income countries to deal with shocks. One of the most appropriate mechanisms could be to increase significantly access under the PRGF arrangements (called PRGF augmentation in recent IMF analysis), to diminish conditionality and to make conditionality more supportive of growth and poverty reduction. A significant matter of concern would then be whether the resources available for PRGF are sufficient to meet the liquidity needs of low-income countries facing external shocks.

40. For low-income countries that do not have PRGF arrangements, but are eligible for this facility (around half), there are a number of options for financing shocks outside their control. One option could be to liberalize access to the Compensatory Financing Facility, liberalize its conditionality and introduce a subsidy element into it for low-income countries. Another option 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.

41. Low-income countries are also vulnerable to natural disasters. In early 2005, IMF agreed to subsidize emergency assistance for natural disasters to PRGF-eligible members. However, the total amount allocated is very limited, and has mostly been used up in the first few months.

## E. Conditionality of IMF lending

42. As important as IMF lending facilities is the conditionality attached to them. Conditionality in IMF-supported programmes was introduced in the 1950s and incorporated as a requirement into the Articles of Agreement in 1969. Until the 1980s, conditionality mainly focused on monetary, fiscal and exchange rate policies. However, in the late 1980s, and especially in the 1990s, IMF financing was also increasingly made conditional on structural changes involving policy processes, legislation and institutional reforms. This resulted in a significant increase in the average number of structural conditions in Fund-supported programmes, which climbed from two to three per year in the mid-1980s to 12 or more by the second half of the 1990s. This change was also reflected in increasing numbers of performance criteria, structural benchmarks and prior actions.[3]

43. The increase in the number of structural conditions raised concerns that IMF was exceeding its mandate and expertise. It has also been argued that the structural policy conditions attached to IMF loans were too numerous and detailed to be fully effective. Indeed, the rate of member countries' compliance with Fund-supported programmes fell from over 50 per cent in the late 1970s and early 1980s to around 16 per cent in the 1990s, if compliance is defined as that which permitted the full disbursement of the loan.

44. There were also concerns that excessive conditionality might undermine the national ownership of programmes, thereby impeding their implementation. It has become clear that lack of real domestic ownership is the most important obstacle to

effective programme implementation, and that conditionality is not a substitute for Government commitment.

45. In response to these concerns, in September 2002, the IMF Board of Governors approved new conditionality guidelines, the first revision since 1979. The basic objective of the 2002 guidelines is to streamline conditionality and enhance programme ownership. Accordingly, conditionality is to be focused on policies essential to restoring and maintaining macroeconomic stability and growth, and better tailored to the country's circumstances. Structural issues are to be covered only if critical for these objectives. In this regard, the new guidelines stress a test of "criticality" for any variable selected for conditionality. The guidelines also stress the need to seek national ownership of programmes, but they do not provide any formal guidance on how to identify and foster domestic ownership of sound policies.

46. Progress in implementing the new guidelines is difficult to assess. Since 2000-2001, the first phase of the "streamlining" initiative, the number of conditions per programme has not declined but stayed fairly constant at about 15 per year, which is similar to the average of the 1990s.

47. A key challenge is to determine which actions are critical to the success of programmes. There appears to be no consensus among IMF Executive Directors regarding the extent to which structural conditionality should be streamlined. Also, IMF staff may have different views on the new policy. This can at least partly explain why conditionality streamlining has been so slow.

48. Another concern is that reducing the number of structural conditions in Fund-supported programmes may lead to an expansion of conditionality by the World Bank, with the aggregate conditionality burden remaining unchanged or even increasing. There are differences in mandates, cultures and structures between the two organizations. Finding the appropriate collaborative framework is an issue of great priority.

## F. Sovereign debt restructuring

49. A number of proposals have been discussed in the international financial community to provide a more orderly resolution of financial crises caused by excessive external indebtedness. A sovereign debt restructuring mechanism, collective action clauses in sovereign bond contracts and a code of conduct for private creditors and sovereign debtors have all been proposed.

50. In 2001, IMF reformulated proposals for a debt workout mechanism based on private sector bankruptcy legislation in the form of the sovereign debt restructuring mechanism. The proposal sought to provide a legal framework to deal with restructuring of debt in an orderly manner. It met with opposition by private and Paris Club creditors, as well as by some developing countries that preferred voluntary arrangements.

51. Collective action clauses enable a qualified majority of bondholders to make decisions that become binding on all bondholders and specify voting rules. This allows Governments facing difficulty in servicing their bonded debt to declare a standstill without exposing themselves to disruptive legal actions.

52. In 2004 and the first quarter of 2005, close to 90 per cent of sovereign bond issues, in value terms, governed by New York law included collective action clauses. The share of issues with such clauses in the total value of the outstanding stock of sovereign bond issues from emerging market countries grew from 39 per cent at the beginning of 2004 to 47 per cent at the end of February 2005. The inclusion of collective action clauses has not led to an increase in the cost of borrowing.

53. One difficulty with reliance on collective action clauses as a substitute for the creation of a more formal mechanism is that only newly issued bonds would contain such clauses, so that it would only resolve the collective action problems once all outstanding bonds are retired. Experience with the aggregation, facilitated by collective action clauses, of a large number of dispersed individual claims has been limited to countries that have issued bond debt on a relatively small scale, such as Ecuador, Moldova, Pakistan, Ukraine and Uruguay. It remains to be seen if the problems of aggregation can be resolved for larger sovereign debtors.

54. The objective of the code of conduct for private creditors and sovereign debtors is to develop a comprehensive voluntary framework to address potential debt servicing problems while preserving contractual arrangements to the maximum extent possible. The idea is to have a voluntary dialogue between debtors and creditors to promote corrective policy action to reduce the frequency and severity of a crisis and establish procedures which would lead to an orderly debt workout. The International Monetary and Financial Committee of the IMF Board of Governors and the Group of Seven finance ministers encouraged sovereign debtors and private creditors to continue their work on the voluntary code of conduct.

55. The voluntary code of conduct is perceived by debtors as a framework in which they can formally engage creditors and provide information to them. It is expected that an early dialogue between issuers and investors will lead to a quick rehabilitation of debtors and restore market access. Whether voluntary efforts along these lines, can provide a sufficiently strong basis for an effective crisis resolution mechanism has yet to be tested.

## G. The role of Special Drawing Rights in the international financial system

56. The creation of Special Drawing Rights (SDRs) in 1969 was an important advance in the design of the international financial system. No allocations of SDRs to IMF member countries have been made since 1981. The IMF's Board of Governors did approve in 1997 a special one-time allocation of SDRs that would have doubled cumulative SDR allocations to SDR 42.9 billion and would have corrected the fact that new IMF members (since 1981) have never received an SDR allocation. However, this decision has not yet been put into effect.

57. The cessation of SDR allocations had negative effects for developing countries, as it coincided with the growing demand for international reserves noted in section I above. There are therefore clear benefits from internationally issued reserves which, together with emergency financing during crises, would provide developing countries a "collective insurance" that is cheaper and therefore more efficient than "self-insurance" via foreign exchange reserve accumulation.

58. Proposals to renew SDR allocations have been increasing in recent years. They follow two different models. The first calls for SDRs to be issued on a temporary basis during episodes of financial stress, to be destroyed once financial conditions normalize. This would introduce a counter-cyclical element in world liquidity management, as sudden drops in private lending would be partly compensated by increased official liquidity. Total long-term liquidity would not increase, since normalization of private lending would imply a cancellation of those SDRs issued during the preceding crisis. Output in developing countries currently lowered by temporary shocks would be higher than otherwise, and the risk of additional world inflation would be minimal.

59. This proposal would solve the problems of adequately financing needs for extraordinary and temporary official liquidity, but not the distributive issues associated with uneven distribution of seigniorage benefits. The solution to this problem requires permanent SDR allocations. Such allocations could go (directly or indirectly) to developing countries only or to the entire Fund membership. The former would favour the countries most in need. Alternatively, SDRs allocated to industrial countries could be used to finance important international objectives, particularly increased international development cooperation. Given the small size of the increase relative to global liquidity this should have little impact on global financial stability.

## H. Increasing South-South cooperation in the international monetary system

60. The large build-up in reserves in many developing countries could be used to enhance South-South cooperation by supporting regional and subregional development banks such as the Arab Bank for Economic Development in Africa, the Islamic Development Bank, the Caribbean Development Bank and the Andean Finance Corporation, or regional development funds such as the International Fund for Agricultural and Rural Development, the Arab Fund for Economic and Social Development and the Organization of Petroleum Exporting Countries (OPEC) Fund.

61. Alternatively the creation of regional reserve funds provides a possible complement to multinational and national mechanisms and reduce the need for extra reserve balances to insure against capital account crises. The large currency crises of the last decade have been regional in nature. Despite contagion, critical demands for funds are not simultaneous and this suggests a useful role for regional reserve funds as a first line of defence during crises. Besides, regional institutions can play a stronger role in relation to small and medium-sized countries, which usually get less attention than larger countries and have a weaker bargaining position with multilateral institutions. Greater attention, especially in East Asia, to the formation of regional financial arrangements may also reflect the slow pace of reform of the international financial system, and particularly the limitations of multilateral official emergency lending.

62. Existing regional financial arrangements among developing countries are in an embryonic stage. The valuable role that regional reserve funds can play is illustrated by the Latin American Reserve Fund formerly the Andean Reserve Fund. Its main function is the provision of short-term liquidity support to countries in crises. Though the total of its loans has been relatively small (between 1979 and 2004, it

disbursed loans of $4.9 billion), its provision of exceptional financing was equal to 60 per cent of the amount lent by IMF to the Andean countries during the same period. In some instances, this institution was the only one to grant loans, as in the case of Peru in 1988, at a time when IMF was not lending at all. Disbursements of loans have always been rapid.

63. After the East Asian crisis, an Asian monetary fund was considered. Though the proposal was well received throughout the region, only a more modest version was created in 2000, when the Association of Southeast Asian Nations, China, Japan and the Republic of Korea created a system of bilateral currency swap arrangements known as the Chiang Mai Initiative. They also institutionalized meetings of finance ministers for policy dialogue and coordination, and are working on a plan to establish a surveillance system.

64. Under the initiative, disbursement of 20 per cent of the maximum drawing would be automatic. Since a country drawing more than 20 per cent is placed under an IMF programme, the Chiang Mai Initiative should be considered as complementary to IMF facilities. Its efficacy in responding rapidly to crises has not yet been tested. There is an understanding that the multilateralization of the bilateral swap arrangements that would be required to solve the problems related to the slow speed in arranging series of bilateral swaps would involve a more formalized and rigorous surveillance system.

## I. Enhancing the voice and participation of developing countries in international financial decision-making

65. The Monterrey Consensus stresses the need to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm setting. It encouraged the Bretton Woods institutions to continue to enhance the participation of all developing and transition economies in their decision-making. However, the Consensus goes beyond the Bretton Woods institutions and highlights the need to extend the discussion of voice and participation to other policymaking bodies, including informal and ad hoc groups.

66. The Bretton Woods institutions have taken limited action to make the participation of developing countries more effective, inter alia strengthening the offices of African directors in IMF and establishing an Analytical Trust Fund to support the African chairs at the World Bank. Also, modalities for consultations in the Basel Committee on Banking Supervision and the Financial Stability Forum have widened.

67. Nevertheless, there has been little progress in the crucial issue of participation of developing countries in decision-making. For instance, all members of the Basel Committee are developed countries: 10 Western European countries, Canada, Japan and the United States. There is no representation of developing countries in the Committee, although it does liaise with developing and transition economies. However, consultations are no substitute for having a seat at the decision-making table. A Basel Committee with more appropriate representation could not only result in a fairer system, but in better regulation leading to a more stable financial system with welfare-enhancing effects for all.

68. The question of strengthening representation of developing countries is now clearly on the agenda of the Bretton Woods institutions. The report of the IMF Executive Board to the International Monetary and Financial Committee of 24 September 2004 on quotas, voice and representation (IMF document IMF/Doc/10/04/4) lays out the elements that would need to be considered to make additional progress on these questions: a general quota increase with a relatively large selective element allocated by means of a new quota formula; ad hoc quota increases with the objective of addressing the clearest cases where the relation between quota and economic size is significantly out of line; and an increase in basic votes to correct the erosion of voting power of countries with small economies.

69. The way quotas are calculated is central to the relative voting power of individual countries and country groupings. Also, the individual country quota determines the amount of financing the country can obtain from the Fund. Currently, the formula to calculate the quota includes gross domestic product or gross national income at market exchange rates, current account transactions, official reserves and a measure of variability of receipts in foreign currency (e.g. exports of goods and services plus income revenues).

70. Without changing the Articles of Agreement,[4] there could be several modifications to the method of calculating the quota that would lead to a comparatively larger share for developing countries as a whole. Those widely mentioned in current discussions include: using the gross national income measured in purchasing power parity instead of gross national income at average exchange rates as a measure of economic size in the quota formula; excluding the volume of trade among members of the European Union that adopted the euro, as such trade does not generate potential balance-of-payments difficulties; and increasing the coefficient assigned in the quota formula to the indicator of variability of receipts.

71. The first of the aforementioned factors could be the most critical in redefining quotas. As table 4 indicates, the use of purchasing power measures of gross national income would increase the quota of developing countries. Most of the increases in the quota share would go to developing Asia countries and, particularly, to China, India and Korea. Indeed, the quota share of developing Asia is barely 17 per cent while its share of gross national income (purchasing power parity) is 28 per cent. This would require, as figures also suggest, a significant adjustment of the share of the European countries, whose quota share as a whole is one and a half times their share of gross national income (purchasing power parity).[5] In any event, a sizeable quota increase with a substantial component targeted to improve the position of developing countries would be necessary to move in the desired direction. An adjustment in relative positions can only be implemented by measurable increases for countries whose calculated quota is higher than actual quota unless those countries with lower calculated quota than actual quota accept a lower absolute quota.

Table 4
**Shares in world total of IMF quotas and gross national income (purchasing power parity), 2002**

| *Country or region* | *Per cent share of total IMF quotas* | *Per cent share of world gross national income (purchasing power parity)* |
|---|---|---|
| United States | 17.4 | 21.5 |
| Japan | 6.2 | 7.1 |
| European Union 25 | 32.2 | 22.5 |
| Other European | 8.5 | 5.9 |
| Australia, Canada, New Zealand | 4.9 | 3.3 |
| **Subtotal** | **69.2** | **60.3** |
| Developing countries | 30.8 | 39.8 |
| Memorandum item | | |
| Brazil | 1.4 | 2.8 |
| China | 3.0 | 12.2 |
| India | 2.0 | 5.8 |
| Republic of Korea | 0.8 | 1.7 |

*Source*: IMF, *International Financial Statistics*; World Bank, World Development Indicators 2004; and estimates by the Department of Economic and Social Affairs.

72. Enhanced representation of countries with small economies can only be achieved by restoring basic votes to close to their original weight. Basic votes initially accounted for about 11 per cent of total voting power in the Fund. With the increases in quotas since the creation of the Fund and no adjustment in basic votes, the latter now represent only 2 per cent of total voting power. This 2 per cent is even more insignificant when the increased size of the IMF membership is taken into account.

73. In the end, adjusting the way the variables are defined and the magnitude of the coefficients used for each variable in the quota formula depends on acceptance by the members of the IMF Board and, by analogy, of the World Bank. This, as well as changes in representation in other international financial institutions, essentially requires political determination, which is still lacking.

# II. Policy conclusions

74. **Developing countries continue to experience net outflows of financial resources despite their lack of sufficient resources to fully exploit their growth potential. For many countries this represents a preference for liquid foreign reserve balances to protect against the volatility of international capital flows and the resulting vulnerability to financial crisis. Measures to increase the stability of the international financial system and to provide more attractive means to access liquidity in periods of turbulence would reduce the attractiveness of large individual country reserve balances.**

75. **Part of the outflow of resources from developing countries is represented by a build-up of reserves in multilateral development banks. Steps should be taken to ensure that these funds continue to be used to support growth and poverty reduction in the poorest developing countries and provide liquidity support mechanisms in middle-income countries.**

76. **In recent years, developing countries have taken a wide range of measures to counter the pro-cyclicality of international capital flows. Nevertheless, these countries remain highly vulnerable to global uncertainties and risks. The transformation of the global financial system has increased the likelihood of boom-bust cycles. This calls for the introduction of a modified, system-wide approach to prudential regulation which takes into account the macroeconomic consequences of financial imbalances and the inherent pro-cyclicality of financial markets.**

77. **Multilateral surveillance remains at the centre of crisis prevention efforts. With the advent of financial globalization, surveillance should focus not only on crisis-prone countries but increasingly on the stability of the system as a whole, with special emphasis on the policy consistency of major economies.**

78. **Greater volatility of liberalized capital accounts has increased the need for official liquidity. The availability of emergency financing at the international and regional levels contributes significantly to both crisis prevention and management. There is the need for easier, more automatic and rapid access to liquidity support. By increasing available financing, as well as reducing its conditionality, the burden of adjustment can be eased significantly.**

79. **Collective action clauses that make it easier to restructure sovereign bonded debt have become the market standard. At the same time, there has been much less progress in providing institutional mechanisms for the debt problems facing middle-income countries. Efforts should continue to reach agreement on a mechanism that ensures fair burden sharing between debtors and creditors.**

80. **Voice and effective participation are issues that go to the centre of the international financial institutions' legitimacy, relevance and effectiveness. Over the past several years, there have been extensive, mostly technical discussions of the issue, but very little progress. While such discussions can be useful in elaborating the details of various proposals, real changes in representation can only be achieved through fundamental reform that has to come from political leaders.**

*Notes*

[1] The net financial transfer of resources 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] For an extensive discussion of changes in the structure of financial markets and implications for prudential regulation and supervision, see *World Economic and Social Survey 2005: Financing for Development* (United Nations publication, Sales No. E.05.II.C.1), chaps. I and VI.

[3] "IMF approves new conditionality guidelines ...", *IMF Survey*, vol. 32, Supplement 2003, 15 September 2003.

[4] A decision to increase the number of basic votes would also lead to an increase in the share of the voting power of developing countries, in particular of the small-economy countries (see para. 72). However, such a decision requires an amendment to the IMF Articles of Agreement.

[5] Several observers have suggested that this should be seen in the context of European Union policies and the possibility of one chair representing the Union.