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Report of the Secretary-General

Summary

The present report, submitted in response to the request contained in General Assembly resolution 61/187, complements the reports of the Secretary-General on the follow-up to the outcome of the International Conference on Financing for Development (A/62/__), and on debt crisis and development (A/62/__). It reviews recent trends in international official and private capital flows to developing countries and recent efforts to strengthen international institutions concerned with expanding the flow and stability of development financing.

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

A. Net resource outflows from developing and transition economies increased in 2006

1. In 2006, the paradox of the increasing net outward financial flows from developing to developed countries persisted, from 533 billion United States dollars ($) in 2005 to $662 billion in 2006 (see table 1). The size of net transfers from countries with economies in transition also increased in 2006, from $112 billion to $133 billion.

2. The financing of the widening current account imbalances is behind this paradoxical pattern. While these imbalances are expected to moderate in 2007, their levels and persistence raise questions about their rationality. The implicit financing mechanism is based on the build-up in international reserves by developing countries to unprecedented levels. This application of investible funds by public authorities in developing countries to reserves poses opportunity costs for developing countries, since these resources could have been applied towards increased domestic investment. Moreover, the policies needed to absorb the reserves build-up become increasingly harmful to the domestic economy through higher interest rates and more risky credit expansion.

3. This net increase in total financial transfers from developing and transition economies includes within it the continued and substantial positive net private capital flows to these countries. This trend on the part of the private sector of increasing exposure to, and investing in, developing and transition economies heightens the concurrent paradox of developing country public authorities devoting resources towards investing in developed country financial assets.

B. Increased private sector flows and risk taking in developing and transition economies

4. The pattern of high levels of private capital flows to developing countries since 2002 continued in 2006. These flows appear to be driven on the one hand by an improvement in perceived risks and on the other hand by strong global liquidity. With respect to risks, these have been contained by sound macroeconomic fundamentals in a number of developing countries that have been reflected in continued improvement in credit ratings.[1] As a result, the spreads on emerging market sovereign bonds are at historically low levels. At the same time, several years of non-restrictive monetary policy and an ample supply of global savings have combined to boost liquidity.[2] These factors have resulted in low levels of financial market volatility across a broad range of assets and an increase and broadening in private capital flows to emerging markets, involving demand for both foreign and local currency denominated assets.[1]

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[1] International Monetary Fund, *Global Financial Stability Report: Market Development and Issues* (Washington, D.C., 2007).

[2] World Bank, *Global Economic Prospects 2007: Managing the Next Wave of Globalization* (Washington, D.C., 2006).

5. The main downside risks to this situation arise from the likelihood that improving fundamentals, on their own, may not fully explain the recent increases in asset prices in some developing countries. The concern is that this is likely to reverse at some time. Moreover, it can be argued that the strong headline economic indicators in some countries may be masking potential vulnerabilities, such as the accumulation of bank lending and private debt in some countries. Another source of concern relates to the increasing prominence of hedge funds, and the lack of transparency and regulation surrounding their activities. Indeed, despite improved risk management techniques, there is concern that there has been greater risk taking in less well-understood markets and instruments. All of this highlights a need for stronger information and oversight to ensure that increasing leverage and risk-taking do not lead to growing vulnerabilities.[3]

6. The episodes of financial market turbulence in early 2006 and in February and March 2007 serve as a reminder of underlying financial risks, though the magnitude and spread of volatility emanating from both these episodes have been contained. The short-lived unsteadiness in equity markets and currencies in early 2006 took place in the context of tightening monetary conditions in the main currency areas and initially featured a general flight from risk with equity markets that had seen the largest run-up in prices since 2005 experiencing some of the biggest declines (e.g., Argentina, Colombia, Hungary, India, Peru, Poland, the Russian Federation and Turkey). However, investors later began to discriminate among emerging markets on the basis of perceived economic fundamentals, during a second phase of correction that took place in June.[4] Despite the market turbulence in the second quarter of the year, overall high levels of portfolio equity flows to developing countries were registered in 2006 owing to healthy overall fundamentals and growth rates in key developing countries, a series of initial public offerings in countries such as China, and the interest of a broader spectrum of investors in the asset class. Longer-term investors such as pension funds have been increasing their allocations to emerging market equities. While interest in corporate equity placements and emerging market stocks is likely to continue, this outlook could change in the wake of a slowdown in the global economy and/or a contraction in global liquidity.

7. External debt issuance by countries declined as improved fundamentals and increased reliance on domestic funding reduced external financing requirements and sovereigns aggressively retired debt. There was an accelerated ongoing buyback of outstanding bonds in 2006 by countries such as Brazil, Colombia, Mexico and the Bolivarian Republic of Venezuela.[5] However, private corporate bond issuance has grown and rose to a record level in emerging markets in 2006. In particular, there has been a rapid expansion of corporate debt issuance in emerging Europe, led mainly by domestic banks. In addition, there has also been increased issuance and demand for local currency debt, reflecting better fundamentals, greater foreign investor appetite and a growing domestic institutional investor base.[1]

8. Commercial bank lending to developing countries grew strongly in 2006, reflecting commercial banks' search for higher returns amid strong competition in mature markets. The high level of commercial bank lending has also been

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[3] International Monetary Fund, *World Economic Outlook 2007: Spillovers and Cycles in the Global Economy* (Washington, D.C., 2007).

[4] Ibid., *World Economic Outlook 2006: Globalization and Inflation* (Washington, D.C., 2006).

[5] *World Economic Situation and Prospects 2007* (United Nations publication, Sales No. 07.II.C.2).

influenced by a benign corporate default environment and a high recovery rate on loans. In particular, there was a surge in lending by commercial banks in the advanced countries to Central and Eastern Europe in 2005 and 2006, giving rise to concerns about excess accumulation of debt in some of these countries. According to the Institute of International Finance, Emerging Europe is likely to receive about 70 per cent of net commercial bank lending to emerging markets this year.[6] Having said this, the levels of commercial bank lending to developing countries have been restricted by factors such as the repayment of short-term loans by some local companies and efforts to limit borrowing in some developing countries in order to reduce credit growth.

C. A slowdown in efforts to increase the aid effort beyond debt relief

9. There has been a significant recovery of official development assistance (ODA) since the International Conference on Financing for Development, held in Monterrey, Mexico, in 2002. Additional commitments were made in 2005 by both the European Union and the G7. From 0.2 per cent of gross national income (GNI) at the Monterrey Conference, ODA posted a rising trend until 2005 when it stood at $106.5 billion, or 0.33 per cent of GNI, but recorded a dip in 2006 at 0.30 per cent of GNI. Moreover, much of the increase in ODA since 2002 is accounted for by debt relief, technical and emergency assistance. Indeed, owing to the large debt relief packages approved in 2005, development aid from Organization for Economic Cooperation and Development (OECD) countries fell by 5.1 per cent in constant dollars in 2006. The Millennium Project estimated that $150 billion would be needed to reach the Millennium Development Goals by 2015. Even if ODA reached 0.36 per cent of GNI by 2010, this would still be lower than the 0.5 per cent achieved in the early years of the Development Assistance Committee (DAC) and below the 0.7 per cent target. This is a matter of concern since during a period in which DAC commitments have been made, actual realization has fallen short.

10. That the decrease in the level of total aid in 2006 is explained mainly by debt relief to heavily indebted poor countries raises both conceptual and policy issues. In theory, debt relief could count towards resources released for development, but because of varying levels of arrears among countries regarding the repayment of external debt, the programme in effect constituted a write-off of payment arrears, not of the outstanding debt itself, and counted as ODA. This means that the resources released for development, were in actual practice, much smaller than those indicated by aid statistics.

II. Reforming the international financial architecture

A. Governance reform at the Bretton Woods institutions

11. Net financial flows from the Bretton Woods institutions have tended to be negative, in some years significantly, in the last 10 years (see table 2). Since, in the current context, their financial operations are directed at developing countries, this

[6] Institute of International Finance, Inc., "Capital Flows to Emerging Market Economies" (January 2007).

pattern raises profound questions about the role of these institutions in financing for development. This trend has raised many questions about their continued relevance and effectiveness. The growth of other sources of financing for development, both private and public (most notably in Latin America), the proliferation of prepayments on loans, the expansion of "self-insurance" reserves — which started in East Asia — among countries, and the relative unattractiveness of the conditionality-based lending from these institutions have compounded the overall deterioration at the international level in the spirit, principles and practices of multilateral cooperation on which these institutions are founded.

12. Progress in restoring the relevance of these institutions is an exercise in reinvigorating the role of multilateral cooperation in addressing critical international problems. In the context of the call by Heads of State and Government in the Monterrey Consensus for "the full and effective participation of developing countries and countries with economies in transition to help them respond effectively", the international community has embarked on reform of the governance processes in these institutions. The Bretton Woods institutions were founded in the aftermath of the Second World War in a spirit of mutual responsibility, before a large scale donor-driven official development assistance industry emerged. The overall inspiration of the current reforms is to reinstate the extent of accountability these institutions had to the users of their resources, as was the case when they were originally established.

13. The effectiveness and legitimacy of these institutions in pursuing their assigned objectives can be attained only if their agenda and decisions better reflect the needs and concerns of the majority of countries affected by their operations. The need for changes in voice and representation, to reflect the economic importance of many emerging market economies and to ensure that low-income countries are adequately represented, has been recognized.

14. On 18 September 2006, the IMF Board of Governors adopted a resolution on quota and voice reform.[7] As stated, the two main goals of the reform are ensuring that the distribution of quotas adequately reflects member countries' economic weight and role in the global economy as well as enhancing the voice of low-income countries. As a first step, the reform programme made ad hoc quota increases for a group of the most clearly underrepresented countries. It also outlined a plan of action for more fundamental reforms, including an agreement on a simpler and more transparent quota formula.

15. The resolution called for at least a doubling of basic votes that would protect, at a minimum, the existing voting share of low-income countries as a group as well as for subsequently safeguarding the proportion of basic votes in total voting power. A broad agreement on the required amendments to the Articles of Agreement to increase basic votes has already been reached. The augmentation of basic votes recommended by the resolution is aimed only at avoiding further erosion of the voting power of low-income countries as a result of upcoming increases in the Fund's total quota. This, however, does not address the substantial prior decline in the share of basic votes which now, with 184 members, constitutes only 2.2 per cent of total voting power, as a result of previous quota increases unaccompanied by

[7] "IMF Board of Governors Approves Quota and Related Governance Reforms", IMF Press Release No. 06/205, available from www.imf.org, accessed 28 June 2007.

adjustments in basic votes. Basic votes initially constituted about 11.4 per cent of the total voting power in the Fund when they were only 44 members.

16. In the case of the new quota formula, what is being sought is a basis for a second round of ad hoc increases to address a broader range of cases of substantial underrepresentation. Agreement on a new quota formula has to be reached by the 2007 Annual Meetings and no later than the 2008 Spring Meetings. In the 2007 Spring Meetings, there was little evidence of progress towards a consensus on the quota formula.

17. If the reform process is to be consistent with its overall goal of redressing inequities in voting weights, the final outcome should ensure that the consolidated share of developing countries is not reduced. A reduction in the total developing country share will mean that the increase in the share of some emerging markets would be at the expense of all other developing countries. Furthermore, if the shares of low-income countries are preserved as a result of an increase in basic votes, such a reduction in the total developing country share could also be at the expense of a selected group of middle-income countries.

18. The World Bank has also launched its own process of redressing voting weight inequities in its governing board. At its April 2007 meeting, the Development Committee welcomed the staff report setting out a range of options for enhancing the voice of developing and transition countries in the Bank's decision-making framework.[8] The report reviews options considered in previous Development Committee meetings, Board of Governors discussions and during various consultations.[9] The Committee also called for further consultations on Bank governance issues to reach a political consensus. Renewed debate on World Bank governance is welcome and timely.

B. Multilateral surveillance

19. Surveillance is a key IMF tool in its assigned responsibility of preventing crises and promoting macroeconomic stability. Looming over the surveillance reform currently under way at IMF is the recent insufficiency of the Fund's influence in alleviating the exploding global financial imbalances through policy adjustments of large economies.

20. There is an understanding that surveillance should focus more on multilateral and regional issues, on the international linkages and on the spillover impact of members' macroeconomic and financial policies on other countries, recognizing the role of the largest economies, rather than attempting to provide advice on a broad range of domestic policies that may go beyond the Fund's core mandate. It is necessary to further strengthen the integration of bilateral, regional and multilateral surveillance. Moreover, the Fund's capability to monitor financial sector and capital market developments, particularly at the global level, needs to be brought up to par with its other core areas of expertise in surveillance.

[8] Development Committee Communiqué (Washington, D.C., 15 April 2007), available from www.worldbank.org, accessed 17 April 2007.

[9] World Bank, "Options Paper on Voice and Representation, Final Update Report" (6 April 2007), available from www.worldbank.org, accessed 19 April 2007.

21. One of the most important components of the surveillance system is the 1977 decision entitled "Surveillance over Exchange Rate Policies", which was drafted in the wake of the collapse of the Bretton Woods system of fixed exchange rate parities. In June 2007, the IMF Executive Board approved an updating of the decision,[10] the first major revision of the surveillance framework in almost 30 years. The chief goal of the revision is to clarify the focus, scope and modalities of surveillance in the context of the changing structure of the global economy, drawing on the best practices already being used in Article IV consultations. To the three existing principles guiding members' exchange rate policies (namely, to avoid manipulating exchange rates in order to prevent balance of payments adjustment or to gain an unfair competitive advantage; to intervene in the exchange market to counter disorderly conditions; and to take into account in intervention policies the interests of other members) the revised decision adds a fourth principle: "A member should avoid exchange rate policies that result in external instability". This addition reaffirms that the main goal of surveillance should be to promote countries' external stability. The revised decision also contains the commitment to an even-handed treatment of members and to due regard to countries' particular circumstances.

22. While the need to enhance exchange rate surveillance as well as to extend this exercise to the currencies of the major emerging economies is recognized, there is strong opposition to the publication of exchange rate assessments that could destabilize economic and financial stability. The prevailing view is that surveillance over exchange rates should focus on whether the adopted exchange rate regime is appropriate and consistent with a member's macroeconomic policies within the global and regional context rather than on the level of the exchange rate per se.

23. In parallel to the effort to reform the surveillance procedure, a new vehicle for multilateral consultations, involving large members and regional groupings, was established to complement surveillance activities. The focus of the first multilateral consultations involving China, the Euro Area, Japan, Saudi Arabia and the United States is on narrowing global current account imbalances while maintaining robust growth. In a report to the International Monetary and Financial Committee of the IMF Board of Governors (IMFC) in April 2007, participants in the talks made important commitments aimed at reducing global imbalances. According to IMF, policies outlined by the countries, if implemented, could reduce global imbalances by 1.0 to 1.75 per cent of global gross domestic product (GDP) over the next four years from a baseline of about 6.0 per cent.[11]

24. If the proposed reform of the surveillance process is to succeed at restoring the effectiveness of surveillance by IMF, the new mechanism should enhance focus and even-handedness; otherwise, IMF will be seen as a player which is partisan to specific interests unable to play the role of an honest broker. Whatever the quality of the Fund's surveillance, its effectiveness will ultimately depend on each country's willingness to adhere to the principles of multilateral cooperation.

[10] See IMF Public Information Notice No. 07/69 (21 June 2007), available from www.imf.org.
[11] *IMF Survey*, vol. 36, no. 7 (23 April 2007), p. 103.

C. International standards and codes

25. The year 2007 marks the introduction of the more risk-based international capital adequacy framework — Basel II (International Convergence of Capital Measurement and Capital Standards: a Revised Framework).[12] Advanced indicators suggest that Basel II is likely to be implemented very widely. Indeed, according to the Financial Stability Institute survey published in September 2006,[13] in addition to the 13 member countries of the Basel Committee on Banking Supervision,[14] at least 82 non-members plan to implement Basel II.

26. In most countries, all banking organizations will be required to adopt Basel II because Basel I will be superseded when Basel II takes effect. Basel II will apply worldwide to a broad spectrum of institutions at different levels of sophistication. Proponents claim that Basel II recognizes the growing diversity of banks within individual countries and across countries because it incorporates several approaches and options as well as a large measure of national discretion. Along with its emphasis towards a more risk-focused capital framework, supervisors worldwide will have to deal with the issue of how to best tailor regulations to a diverse group of institutions.

27. In most developed economies and in accordance with the Basel Committee schedule, the implementation is to start in 2007. Developing countries which plan to implement Basel II intend to introduce the new framework no later than 2015. In these countries, the major objective is a general overhaul of banking supervision and the upgrading of banks' risk management by introducing what are considered best practices as embodied in Basel II.

28. The impact of Basel II on developing countries is of two types: (a) the impact on the level and stability of flows and on how these flows could exacerbate booms and busts of private financial flows from developed to developing countries as a result of its implementation in industrial economies; and (b) the direct impact of their implementation in the developing countries themselves. In the first type, views have ranged from increased boom-bust cycles[15] to reduced levels of flows on one end of the spectrum, to a quantitatively insignificant impact on the other end. It is in the second type of cost where there is less ambiguity. The prospective cost of implementing Basel II in developing countries is extremely high because of the level of sophistication in the kind of oversight and regulation it would require. For example, well-trained personnel, the supply of which is already scarce, now working in the financial sectors in developing countries, might have to be diverted to operate the regulatory regime. In comparison, the returns to this costly investment

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[12] For a discussion of Basel II, see *World Economic and Social Survey, 2003* (United Nations publication, Sales No. E.03.II.C.1), chap. II.

[13] "Implementation of the new capital adequacy framework in non-Basel Committee member countries", Occasional Paper No. 6, Financial Stability Institute (September 2006), available from www.bis.org/fsi, accessed 15 May 2007.

[14] Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom of Great Britain and Northern Ireland and the United States of America.

[15] Griffith-Jones, S., and others, "The Onward March of Basel II: Can the Interests of Developing Countries be Protected?" University of Sussex, Institute of Development Studies (July 2002), available from http://www.gapresearch.org/finance/Conferencepaper2.pdf, accessed 27 June 2007.

would likely be minimal[16] since the system was not designed for developing countries.

29. In contrast to most other countries, the United States will apply Basel II to only a handful of large, complex financial organizations. The United States regulators concluded that for small, non-complex banks, the implementation costs of Basel II would exceed the regulatory benefits. Consequently, the vast majority of United States banking institutions will continue to operate under Basel I-based rules, which are being amended to increase their risk sensitivity (the so-called Basel IA). The main intention behind Basel IA is to mitigate competitive disadvantages for small banks that might be created by introducing Basel II for large institutions. Banks not electing to use Basel IA could continue to use Basel I unless regulators decide otherwise.

30. According to the United States regulators, the combined framework of Basel I, IA and II reflects the view that “one size does not fit all” in diverse banking environments. A more varied approach is seen as preferable to a single capital framework which would be overly burdensome for smaller banks or too simplistic for larger institutions. In the United States, the implementation of Basel II will be phased in over a number of years to give banks, markets and regulators time to learn and adjust to the new standards. Consequently, the full implementation of the new framework may not be until 2012 at the earliest.

31. The differences in the timing of implementation, especially between the European Union and the United States, present significant, though transient, problems for international firms and banks with operations in jurisdictions adopting different timetables for implementation. The lack of cross-country uniformity of regimes for capital regulation for a substantial period of time may lead to extra complexity and costs.

32. Another problematic area concerns questions of how bank regulators in different countries, once they have converged on a timetable for implementation, will converge on the interpretation of key concepts and definitions of Basel II. The counterpoint to the much-needed flexibility in the framework is lack of clarity on a regulatory approach to various implementation issues, especially in cross-border situations. The national discretion allowed under Basel II and the resulting adoption of different approaches to the new capital framework by various countries have heightened concerns about possible problems in achieving a degree of international consistency in the capital regulation.

33. These concerns have been the subject of extensive consultations between national regulators and the Accord Implementation Group of the Basel Committee on Banking Supervision. Such a dialogue is deemed essential to identify differences in implementation and to discuss possible ways to harmonize basic rules as well as different approaches that countries are considering to address capital adequacy beyond the regulatory minimum. Given the growing number of countries involved in implementation as well as the different states of development of their banking systems, the effective management of the network of supervisory cooperation will be a challenge.

[16] Bailey, R., “Basel II and Development Countries: Understanding the Implications”, London School of Economics Working Paper Series No. 05-71 (December 2005), available from http://www.lse.ac.uk/collections/DESTIN/pdf/WP71.pdf, accessed 27 June 2007.

34. In another regulatory development, at the International Conference of Banking Supervisors held in Merida, Mexico, in October 2006, bank supervisors from 120 countries endorsed the updated version of the Basel Core Principles for Effective Banking Supervision and its Methodology.[17] The Core Principles, which establish international minimum standards for bank regulation and supervision, were originally agreed to in 1997. The updated Core Principles were a response to changes which occurred in banking practices and regulation and to the experience gained with implementing and assessing them. The revisions pay particular attention to sound risk management and corporate governance practices and to the need for closer cooperation and information exchange among supervisors of different sectors and countries.

35. Along with initiatives in banking regulation and supervision, there has been continuing work to strengthen some other segments of the global financial system. At its March 2007 meeting, the Financial Stability Forum (FSF) discussed developments in the hedge-fund sector and the supervisory, regulatory and private sector actions taken in recent years to strengthen market discipline, risk management practices and market infrastructure.[18] Building on this discussion and on the work by its member bodies, the Forum issued, in May 2007, an update of its 2000 report on highly leveraged institutions.[19] The main focus of the update recommendations is on ensuring that investors are provided with an appropriate level of transparency as well as on improving large hedge fund counterparties' risk management practices, which, in many cases, are now considered to be inadequate.

36. The G8 Summit Declaration on Growth and Responsibility in the World Economy, of 7 June 2007, called on the global hedge fund industry to "review and enhance existing sound practices benchmarks for hedge fund managers; in particular in the areas of risk management, valuations and disclosure to investors and counterparties in the light of expectations for improved practices set out by the official and private sectors". The statement also welcomed the report scheduled to be given in October 2007 by the Financial Stability Forum to G8 finance ministers on progress and actions taken on the Forum's set of updated recommendations from its report on highly leveraged institutions.

37. Efforts to strengthen standards and codes emerged in the international agenda following the financial market crises of the late 1990s. This effort did not emerge as the result of a participatory process by all countries however. Rather, standards have usually been adapted from those of industrial countries, mainly the Group of Seven (G7), acting through the Financial Stability Forum, with only a few developing countries present as observers (see E/2007/10 and Corr.1). An unstated assumption is that what works for a G7 economy should work for everyone. The origins of the effort lay in the view that lack of transparency led to misinformed judgements about economies that resulted in herding behaviour and contagion on the part of the private sector. The subdued response of private actors to the Reports on the

[17] "Bank supervisors from 120 countries endorse updated international principles for effective banking supervision", Bank for International Settlements (BIS) press release, 5 October 2006, available from www.bis.org/press, accessed 10 April 2007.

[18] "Seventeenth Meeting of the FSF (Frankfurt a. M., 29 March 2007)", available from www.fsforum.org, accessed 11 April 2007.

[19] "FSF makes recommendations to address potential financial system risks relating to hedge funds", FSF Press Release, 19 May 2007, available from www.fsforum.org, accessed 21 May 2007.

Observance of Standards and Codes weakens this argument and the hope that market discipline would induce sufficient incentive to comply with the codes.

D. Financing for crisis prevention

38. Many important emerging market members have prepaid their loans to the Fund and engaged heavily in self-insurance, as opposed to cooperative insurance through IMF, by building a significant level of international reserves. Regional reserve pooling arrangements have been expanded. The steep growth of the volume of potentially volatile cross-border capital flows suggests that IMF traditional methods of crisis prevention and resolution are much less potent than they used to be. Accordingly, the reserve build-up may be, at least partly, a symptom of uncertainty about the future stability of the international financial system and the efficacy of existing multilateral instruments of crisis prevention. To re-establish its relevance to emerging market economies, the Fund has to have the tools to address the kinds of issues faced by these economies. Through the Fund and regional arrangements, the international community needs to provide mechanisms to avert capital flows crises and to allow emerging market economies continued robust access to private external sources of finance. These instruments and mechanisms must be predictable, flexible and substantial relative to the size of the private capital flows that are now occurring.

39. Since the expiration of the Contingent Credit Line in November 2003, IMF has been exploring other ways to develop a specific access contingent financing vehicle to support crisis prevention efforts by members active in capital markets. In August 2006, IMF staff put forward a sample design of crisis prevention facility, under the name of Reserve Augmentation Line.[20] According to the proposal, the new facility would be available to members with strong macroeconomic policies, a sustainable debt situation and proven credibility in policy implementation but are still faced with vulnerabilities to capital account crises. The adherence by the member to a policy framework that meets the standards of upper credit tranche conditionality would be reviewed by the Board semi-annually. There would be no performance criteria. Access would be 300 to 500 per cent of quota with the full amount being available from the outset if the programme was on track. The Reserve Augmentation Line would be established as part of the Supplemental Reserve Facility with one year in duration.

40. While potential users among the emerging market economies have indicated that the Reserve Augmentation Line proposal is an important step forward, there are still questions on the criteria for eligibility, the size of the facility, and whether the current design results in additional conditionality. It is important to further enhance the reliability of access to financial resources and to reinforce the positive signalling to markets to overcome the potential stigma associated with the facility.

41. It has been suggested that to reduce the uncertainty surrounding eligibility, qualification should be based on objective instead of unduly restrictive quantitative indicators. The facility should qualify a significant number of emerging market members based on the information available from past Article IV reports. By

[20] "Consideration of a New Liquidity Instrument for Market Access Countries", IMF (3 August 2006), available from www.imf.org, accessed 5 September 2006.

allowing automatic front-loaded drawing of up to 500 per cent of quota for eligible members, a clear message on the merits of having an insurance facility could be conveyed to private markets. It is important to establish simple and transparent guidelines to ensure the reliability of the availability of continuous access to Fund resources. It has also been suggested that, to reduce uncertainty and build up credibility, the reviews should be limited to the time of the Article IV consultations and that the facility be extended for a period of at least two to three years. It is also important to clearly differentiate between this precautionary facility and other regular Fund programmes. The proposed creation of Reserve Augmentation Line as part of the Supplemental Reserve Facility, including the rather high charges and commitment fees, may not appeal to members.

42. While the work on a new instrument continues, it is important to take advantage of the favourable current environment to radically rethink the approach to crisis prevention.

43. There have also been proposals, supported at IMFC, to explore the possibilities for more interaction between the Fund and regional financing or reserve pooling arrangements. It has been argued that the Fund can play a more important role here, focusing on surveillance of pool members and signalling sound policies. Fund engagement can potentially strengthen confidence of the pool participants in the economic policies of each other, and may contribute to an increase in scale, scope and effectiveness of regional financial arrangements. IMF engagement would certainly be welcome in this regard. One cannot presume the effectiveness of only a single framework for crisis prevention, crisis management and capital market development, however. There is an advantage in the potential of regional arrangements to contribute to enlarging the variety of policy frameworks. Regional arrangements can put forward alternative approaches, particularly to the highly pro-cyclical IMF approach to capital flows, as had been the initial IMF approach to the Asian crisis in the 1990s. In fact, the subsequent reserve build-up in Asian countries has been seen as at least partly a response to that experience. The emergence of multilateralism at the regional level enhances the likelihood of identifying appropriate solutions and reduces the burden on global institutions and thus strengthens multilateralism globally.

E. International Monetary Fund engagement with low-income countries

44. Subsequent to the transformation of structural adjustment programmes into poverty reduction programmes built on top of Fund macroeconomic programming, IMF has played an increasingly important role in low-income countries through surveillance, technical assistance and concessional lending. These instruments had increased the Fund's policy leverage with low-income countries. Recently, to further strengthen its engagement with low-income countries, a set of new instruments has been created, including the Policy Support Instrument and the Exogenous Shocks Facility. The Policy Support Instrument is designed to address the needs of low-income countries that do not need or want the Fund's financing, but wish the Fund to support, monitor and endorse their policies. As of April 2007, Policy Support Instrument arrangements had been approved for four countries: Cape Verde, Nigeria, the United Republic of Tanzania and Uganda. The experience with the Public Support Instrument will be reviewed in 2008.

45. In helping low-income countries implement macroeconomic policies that foster sustainable growth and support the achievement of the Millennium Development Goals, the Fund is expected to concentrate more on addressing new challenges facing this group of countries, including effective management of the expected increase in aid flows, maintenance of debt sustainability and more effective use of the fiscal and balance-of-payments policy space created by debt relief. In this regard, the Fund, in close cooperation with the World Bank and other agencies, will intensify its advice activities to low-income countries on public expenditure management to ensure that additional aid does not lead to wasteful and inefficient spending and on the consistency of projected aid flows with macroeconomic stability, including real exchange rate effects. Attention will also be paid to developing appropriate policies in the event that aid is volatile or is not scaled up as expected. To be effective, an increased capability on the part of both the Fund and the Bank to generate analyses appropriate to the issues and to genuinely draw upon local expertise on the problems to be addressed is indispensable.

46. An April 2007 study by the IMF Independent Evaluation Office on programmes drawing on the Poverty Reduction and Growth Facility for 29 African sub-Saharan countries,[21] indicates that the conceptual and policy challenges in IMF's role in low-income countries continue to be daunting. The report finds that IMF staff focus too narrowly on macroeconomic stability and have severely restricted the utilization by countries of increases they have received in aid flows. Because of this narrow focus, Poverty Reduction and Growth Facility programmed the absorption, on the average, of only two thirds of the additional aid, the rest being applied to increasing international reserves. For countries whose reserves were below the threshold minimum, the study finds that 95 per cent of the additional aid was programmed for increases in reserves. For households in countries that are not only attempting to reduce widespread poverty but are also fighting significant HIV/AIDS epidemics, this stance has profound life-and-death consequences. For donors, the non-arrival of aid disbursements because IMF Poverty Reduction and Growth Facility ceilings could not be breached is unforeseen.

47. The evaluation report suggests that the "disconnect"[22] between aid intentions and IMF programming needs to be addressed through clearer instructions to staff and better communications with donors and partner countries. The Fund should inform donors if, in its judgement, macroeconomic instability poses risks to the utilization of aid. The absorption capacity of the country may be difficult to assess, however. It has thus been pointed out that the Fund should be very careful in passing judgement on the size of the aid flowing into these countries to avoid the risk of being perceived as an obstacle to aid and the achievement of the Millennium Development Goals. Also, there is no consensus on the Fund taking on the role of estimating the costs of achieving the respective countries' development goals.

48. By supporting the Multilateral Debt Relief Initiative, the Heavily Indebted Poor Countries Debt Initiative and other debt relief initiatives, both creditors and debtors agreed to a new framework designed to end the lend-and-forgive cycle in

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[21] Independent Evaluation Office of the IMF, "The IMF and Aid to Sub-Saharan Africa: Evaluation Report", available from http://www.imf.org/external/np/ieo/2007/ssa/eng/pdf/report.pdf, accessed 28 May 2007.

[22] Ibid., Executive Summary.

the least developed countries. To ensure that debt prospects improved by debt relief will not deteriorate through excessive additional borrowing, IMF is expected to expand its assistance in building fiscal and debt management capacity in low-income countries as well as to strengthen debt monitoring under the joint Bank-Fund Debt Sustainability Framework. In this regard, IMFC has urged all creditors and borrowers to work with IMF and the World Bank to use the framework as a tool for fostering coherent and responsible lending practices, identifying emerging debt-related vulnerabilities, and elaborating country-owned debt strategies.[23]

49. Work is under way to refine and enhance the Debt Sustainability Framework and ensure that it is comprehensive, practical, widely accepted and reasonably objective. Recent discussions on the application of the Debt Sustainability Framework have focused on the increased policy space in some low-income countries, rising domestic debt, and the role of new creditors. It is important that the framework include stable and objective criteria consistent with the development needs of the indebted country, particularly its financing needs, to achieve the Millennium Development Goals. Focusing the criteria solely on debt-servicing capacity could lead to insufficient resource allocation for long-term public investments.

50. Advising countries to avoid expensive debt will be more effective if they have increased access to alternative sources of finance. Therefore, efforts towards realizing the promised higher aid, delivered in a more predictable and less conditional manner, are critical.

51. Given the complexity of the multidisciplinary policy design and implementation in the low-income countries, it is essential to have a clear division of responsibilities. For this purpose, it is crucial that IMF and the World Bank engage in further discussions that should lead to a clearer division of labour between the two institutions in terms of responsibilities, financing and accountability. The recommendations made by the External Review Committee on IMF-World Bank Collaboration[24] may be useful in this process.

F. Regional financial cooperation

52. The experience from the 1997-1998 financial crises provoked increased efforts on the part of some developing countries to promote regional financial integration. The regional nature of the crises in the 1990s created a strong stimulus for countries to engage in regional cooperation in order to determine commonly agreed targets and mutual surveillance and to provide mutual assistance mechanisms to preclude the contagion effects of a financial crisis. There are, however, also obstacles to such cooperation, such as the inadequate capacity of countries to provide the necessary financial services, the lack of proper institutional frameworks and the possibility of inequitable distribution of the benefits from such cooperation.

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[23] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, IMF (14 April 2007) available at www.imf.org, accessed 17 April 2007.

[24] Report of the External Review Committee on Bank-Fund Collaboration (February 2007), available from www.imf.org, accessed 10 May 2007.

53. Among the aims articulated by developing countries in these regional initiatives are: creating a forum for policy discussion; elaborating mutual monitoring and surveillance procedures; coordinating exchange rate; and, in particular cases, eventually launching a single currency. The initiatives taken by the members of the Gulf Cooperation Council (GCC) and the countries of the Caribbean Community, which seek the eventual adoption of a single currency, are examples of such strategies. GCC member countries have already eliminated barriers to free movement of goods, services, capital and national labour and introduced a common external tariff. The objective now is to establish a monetary union by 2010. These are also the stated goals in the Caribbean, despite numerous failed attempts in the past.

54. In Africa, a monetary cooperation programme aimed at a single currency and common central bank by 2021 was launched by the Association of African Central Bank Governors. The programme will use the five existing regional unions as an intermediate stage in the process.

55. In Latin America, numerous attempts have been made to create macroeconomic policy coordination frameworks within the major regional integration agreements (such as MERCOSUR (Common Market of the South), the Andean Community and the Community of Central American Countries). Sustaining sufficient incentives for compliance with the declared goals has proven to be difficult, however. Progress made in the region has so far been marginal. In spite of increased integration among the region's countries, mutual support for balance-of-payments financing remains weak and the only working institution in the area for liquidity provision is the Latin American Reserve Fund. This Reserve Fund, though limited in membership (the Andean countries and Costa Rica), was successful in supporting member countries during the debt crisis of the 1980s and during the Asian crisis of the 1990s. In addition to providing financial support to its member States and improving the countries' reserve management, it also has, as an objective, the coordination of the monetary and fiscal policies of its members.

56. In East Asia, the focus of initiatives has been on improving regional surveillance, developing collective liquidity support mechanism and promoting financial development. Such collective actions aim to both reduce the region's vulnerabilities to future financial crises and improve the allocation of savings.

57. The collective liquidity support under the Chiang Mai Initiative has taken the form of bilateral currency swaps agreed to in May 2000 by the Association of Southeast Asian Nations (ASEAN) member countries plus China, Japan and the Republic of Korea (ASEAN+3). The size of the Initiative is approximately $75 billion. Under the arrangement, a disbursement of 20 per cent of the maximum drawing is automatic. Any country drawing more than 20 per cent would have to be taking part in an IMF programme. The regional framework is complementary to the IMF global facilities and does not negate the need for a crisis prevention framework in IMF itself. Because of the benign global environment of the past several years, the effectiveness of the Initiative in crisis prevention has yet to be tested.

58. Chiang Mai Initiative members are seeking to overcome potential problems, such as the slow response of the mechanism under the bilateral swap arrangements in times of speculative attacks. To this end, a collective decision-making procedure for Initiative activation has been adopted that would allow the simultaneous and prompt provision of liquidity support to any party involved in bilateral swap

arrangements. Also, in May 2006, the finance ministers of China, Japan and the Republic of Korea agreed to study further various options towards increasing reserve pooling as well as multilateralization.

59. There is an understanding that the multilateralization of the bilateral swap arrangements would require a more formalized and rigorous surveillance system. Although the ASEAN+3 Economic Review and Policy Dialogue is the most advanced multilateral peer review mechanism in Asia, it is still not strong enough to support reserve pooling arrangements. In this regard, the Group of Experts and the Technical Working Group on Economic and Financial Monitoring have been launched to explore the ways for further strengthening surveillance capacity in East Asia, including the development of the early warning system to detect and assess regional financial vulnerabilities.

60. There have also been efforts to remove institutional and regulatory impediments that constrain the development of more integrated regional financial markets. An important part of these efforts is the Asian Bond Markets Initiative aimed at developing well-functioning, local-currency bond markets in Asia. This initiative has been given important impetus by the introduction of two Asian Bond Funds with the main objectives of diversifying debt financing, encouraging a convergence in financial and capital market policies, recycling regional savings intraregionally and lessening the extent of currency and maturity mismatches. Working groups under the Asian Bond Markets Initiative are currently focusing on the issuance of multicurrency bonds, establishment of a regional credit guarantee mechanism, exploring an Asian clearing and settlement system, strengthening Asian credit rating agencies in conjunction with Basel II implementation, and the development of Asian Bond Standards.

61. The Asian Development Bank (ADB) plays an important role in the promotion of local-currency bond markets. Since 2004, ADB has issued local currency denominated bonds in China, India, Malaysia, the Philippines, Singapore and Thailand. Also, in September 2006, it launched a $10 billion Asian Currency Note Programme. Under the programme, bonds in local currencies will be issued in Singapore, Hong Kong Special Administrative Region of China, Malaysia and Thailand under a single unified framework with a common set of documents. The programme establishes an important link among domestic capital markets in Asia and brings scale and investor demand across regulatory borders. It is expected that the format of a linked, multilocation, multicurrency financing can be applied to other leading issuers, including Asian or multinational corporations seeking to simultaneously access a large base of Asian investors.

62. Along with bond market initiatives, there has been some progress in the development of other capital market segments. For instance, an ASEAN Exchange Traded Fund has been listed on the Singapore Exchange, tracking 40 top companies from Indonesia, Malaysia, the Philippines, Singapore and Thailand.

III. Policy conclusions

63. **The governance reforms and improved multilateral surveillance should be seen as a first step towards the development of a broader-based consultation process. A stronger multilaterally institutionalized mechanism of surveillance and policy coordination is needed.**

64. **Multilateral surveillance remains in the centre of crisis prevention efforts. If the proposed reform of the IMF surveillance process is to be effective, all new surveillance mechanisms should enhance focus, symmetry, objectivity, equity and even-handedness.**

65. **With the deepening of intraregional trade and investment flows, several platforms for regional economic cooperation have emerged. More active use by countries of regional funds and mechanisms for surveillance and policy consultations increases the supply of regionally suited policies and should constructively complement the role of IMF.**

66. **It is important to ensure that standards and codes are mutually consistent and, at the same time, flexible enough to be effectively applied in countries at different stages of financial development. All parties concerned should be more deeply involved in the work of international regulatory and standard-setting bodies, including private entities. Developing countries in particular need to establish the capacity to understand these issues, adapt the use of the codes according to their domestic conditions, and determine the proper timing of their adoption.**

67. **To re-establish its relevance to emerging market economies, the Fund has to have adequate tools for crisis prevention. These instruments and mechanisms must be predictable, flexible, affordable and substantial relative to the magnitude of capital account volatility.**

68. **The Fund's increasingly important role in low-income countries through surveillance, technical assistance and concessional lending should be matched by an increased capability on its part to undertake these activities. Given the complexity of the multidisciplinary policy design and implementation in low-income countries, it is essential to have a clear division of responsibilities and closer cooperation with other institutions dealing with this group of countries.**

69. **The effectiveness of multilateral cooperation critically depends on an adequate voice for, and participation of all, countries. Comprehensive governance reforms aimed at solving the problem of underrepresentation of developing countries in global financial institutions are indispensable at this time.**

Table 1
Net transfer of financial resources to developing economies and economies in transition, 1996-2007

(Billions of United States dollars)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*[a]
Developing countries	23.8	-1.1	-33.7	-118.4	-185.8	-154.7	-204.4	-298.9	-351.2	-533.3	-661.6
Africa	-5.9	-5.3	15.5	2.2	-31.6	-17.2	-7.1	-22.2	-35.8	-66.3	-78.9
Sub-Saharan (excluding Nigeria and South Africa)	5.0	7.7	12.0	8.9	2.8	6.9	5.2	6.3	3.9	2.0	-1.0
Eastern and Southern Asia	18.9	-31.5	-128.1	-137.6	-120.2	-116.9	-145.4	-171.0	-161.6	-231.5	-322.0
Western Asia	10.6	12.6	34.8	7.7	-31.5	-23.9	-19.5	-44.1	-71.4	-129.3	-131.6
Latin America	0.3	23.2	44.1	9.3	-2.5	3.2	-32.4	-61.5	-82.3	-106.1	-129.1
Economies in transition	-11.7	-2.9	-6.7	-32.1	-58.0	-40.3	-38.8	-50.6	-78.0	-111.6	-133.0
Memorandum item: Heavily indebted poor countries	7.2	7.9	9.2	10.6	8.5	9.1	11.5	10.9	11.5	14.5	12.8
Least developed countries	10.5	9.2	12.5	10.8	5.7	8.8	7.2	8.9	5.2	3.7	1.7

Source: United Nations Department of Economic and Social Affairs, based on International Monetary Fund (IMF), *World Economic Outlook Database* (April 2007), and IMF, *Balance of Payments Statistics.*

[a] Estimates.

Table 2

Net flows of financial resources, by selected multilateral institutions, 1996-2005

(Millions of United States dollars)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Net flows[a]	2 060	21 227	28 825	-7 450	10 859	14 931	2 001	-11 655	-20 235	-39 609
Financial institutions, excluding IMF	1 460	6 827	9 525	5 150	-59	1 431	11 199	-14 755	-10 235	835
Regional development banks[b]	2 376	5 334	7 971	4 229	327	1 696	-3 904	-8 025	-6 570	-1 668
World Bank Group	-915	1 493	1 554	921	-386	-265	-7 295	-6 730	-3 665	2 503[c]
International Bank for Reconstruction and Development	-6 128	-3 265	-2 723	-3 019	-4 079	-4 570	12 126	-11 241	-8 930	-2 898
International Development Association	5 213	4 757	4 276	3 940	3 693	4 432	4 831	4 511	5 265	5 401
IMF (billions of dollars)	1	14	19	-13	-11	14	13	3	-10	-40
Memorandum item (in units of 2000 purchasing power):[d]										
Resource commitments (millions of dollars)	54 776	78 696	87 264	62 446	63 085	73 650	97 237	63 171	48 604	60 773
Net flows (millions of dollars)	1 689	18 620	26 445	-7 095	10 859	15 236	2 042	-10 892	-17 596	-33 567

Sources: Annual reports, various issues of the multilateral institutions.

[a] Loans, grants, technical assistance and equity participation, as appropriate, net of repayment; all data are on a calendar-year basis.

[b] African Development Bank, Asian Development Bank, Caribbean Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank (including Inter-American Investment Corporation), and International Fund for Agricultural Development.

[c] Data is for fiscal year 2005.

[d] Totals deflated by the United Nations index of manufactured export prices (in dollars) of developed economies: 2000 = 100.