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The international financial system and development

Report of the Secretary-General

Summary

The present report, submitted in response to the request contained in General Assembly resolution 62/185, complements the reports of the Secretary-General on the follow-up to the outcome of the International Conference on Financing for Development and on the debt crisis and development. It reviews recent trends in international official and private capital flows to developing countries and international policy challenges arising from the financial crisis, which are critical in expanding the flow and stability of development financing. The report highlights the critical role of multilateralism in addressing current economic challenges facing the international community.

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

A. Continued increase in net resource outflows from developing countries in 2007

1. Developing countries continued to make increasing substantial net outward transfers of financial resources to developed countries, reaching $792 billion in 2007 (see annex). In contrast to 2006, the rate of increase in the volume of net transfers has moderated and remains mainly concentrated in Eastern and Southern Asia. Compared to previous years, Latin America and Africa have experienced declines in net resource outflows. Estimates for 2008, however, show that the current trend will reverse for Western Asia and Africa as increasing revenues in oil-exporting countries will significantly contribute to the accumulation of international reserves and net resource outflows from these regions. Net transfers from countries with economies in transition declined from $125 billion in 2006 to $100 billion in 2007, mainly owing to the reduction of the trade surplus in the Russian Federation. A preliminary assessment of net transfers from economies in transition in 2008 indicates a return to levels of previous years.

2. The paradoxical net flow of financial resources from poorer to richer countries has contributed to the pattern of global imbalances, characterized by a large current account deficit in the United States of America and corresponding surpluses in Chile, China, other emerging market economies and oil-exporting nations such as the Russian Federation and Saudi Arabia. In the light of rising financial instability and the global economic slowdown, the risk of a disorderly unwinding of global imbalances has increased.

3. The increase in net outflows in 2007 has been accompanied by continued substantial net private capital inflows to all developing country subgroupings. These private capital inflows are propelled by the abundant global liquidity financed by the aforementioned imbalances and by disequilibrating capital flows centred on the "carry trade" — where investors seek to make a return by borrowing in low yielding currencies and using the funds to buy and lend in higher yielding currencies, thereby earning the spread between the two yields, but remaining subject to exchange rate fluctuations. The expansion of private capital flows has enabled emerging economies to sustain their growth path and helped these countries stay resilient in the face of the ongoing turmoil in developed country financial markets caused by the sub-prime mortgage crisis. However, the increased exposure to these flows leaves developing countries vulnerable to sudden changes in investor sentiment and to a possible deterioration in global financial market conditions. Moreover, emerging markets will not be immune to the economic slowdown in the major economies and potential global deflationary repercussions that emanate from it.

4. Given the recent turmoil in developed countries' credit markets, public investments from emerging markets appear to have played an important stabilizing role in ensuring that contagion did not spread to Government bond markets in developed countries. Moreover, owing to the unprecedented build-up of international official reserves, emerging economy Governments have increasingly taken long-term equity positions in developed countries' financial markets through

sovereign wealth funds. The substantial investments by these funds have been important stabilizers for distressed financial institutions in developed countries.[1]

B. Increased private sector flows in the context of uncertainties and downside risks in the world economy

5. In the current financial turmoil, developing countries have so far proved to be much better prepared than in previous crises. Large currency reserves, improved macroeconomic fundamentals and strong economic growth in emerging economies have all helped to sustain high levels of private capital flows. The limited impact of global financial turbulence on emerging market countries can be explained by the concentration of disruptions mainly in innovative credit instruments in developed countries' financial markets, rather than in those of developing countries.

6. The substantial increase in private capital flows to developing countries has taken place despite evident increased caution on the part of international investors. Some supply-side factors continue to favour institutional investors from advanced countries seeking portfolio diversification and higher returns, as well as sovereign investors from the Middle East and other regions recycling oil-based surpluses. The main risk associated with portfolio equity flows to developing countries in the midst of slowing growth is increased risk aversion, suggesting that the threat of a reversal remains considerable.[2]

7. Foreign direct investment in developing countries, as well as in transition economies, increased sizeably in 2007 and was not noticeably affected by the financial and credit crises. Recent foreign direct investment is broadly based, particularly bolstered by the buoyant profits of transnational corporations and high commodity prices. Both factors strengthened foreign direct investment flows to resource-rich countries in Africa, Latin America and Western Asia. The increase in foreign direct investment (FDI) flows in 2007 was fuelled by a sharp increase in cross-border mergers and acquisitions, which have since declined with the beginning of the financial turmoil in developed countries' financial markets. The observed increase in net flows of foreign direct investment (FDI) into developing countries is net of their own increased outward investments. While firms from East and South Asia have been investing actively in other developing countries in extractive industries, telecommunications and financial services, their mergers and acquisition purchases in developed countries are also on the rise.

8. External debt issuance by developing countries has declined sharply since the beginning of the financial and credit crises for two reasons. One factor is a decreased need for bond finance, due to the increased availability of non-bank debt-related flows through local currency markets. In Latin America, for example, flows into local markets from non-bank private investors now constitute one of the most significant forms of capital inflows. This has led to the reduction of currency mismatches, even though these markets are characterized by short-term maturities. A second reason for lower external debt issuance is the increase of spreads on emerging market bonds. While spreads on sovereign bonds have widened only

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[1] United Nations, *World Economic Situation and Prospects 2008* (New York, 2008).

[2] International Monetary Fund, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness* (Washington, D.C., 2008).

moderately from their historically low levels prior to the financial turmoil in 2007, developing country corporate borrowers are bearing increased additional interest fees on their external borrowings. According to the International Monetary Fund (IMF), corporate debt accounted for 80 per cent of bond issuance during 2007. Should these spreads widen further, credit demand will be pushed into domestic banking systems and increase domestic funding pressures.

9. Net commercial bank lending to emerging market economies has been quite stable despite the weakness in mature credit markets. However, the surge in commercial lending by banks in advanced countries to economies in transition over the past several years is giving rise to concerns about excess accumulation of debt in some of these nations. For many domestic banks in Eastern Europe, credit growth has far outpaced growth in domestic deposits. Given that a substantial part of bank funding is being obtained on international wholesale markets, these institutions have become vulnerable to financial turmoil. A partial near-term withdrawal from emerging markets might be possible, as banks in developed countries tighten credit criteria and assume more risk-averse postures while replenishing reserves after sharp losses in sub-prime securities.

10. Recently published data[3] on issuance in international syndicated loan, bond and equity markets by issuers domiciled in emerging market countries indicate that conditions have shifted significantly since the financial turbulence started in August 2007. A comparison of the period from September 2007 to February 2008 with the same period a year earlier indicates that equity issuance has increased about 30 per cent, while syndicated bank lending has fallen by 24 per cent and bond issuance has decreased by 53 per cent. While the data may reflect lower demand for bond finance as much as reduced supply and do not account for a possible shift from cross-border to domestic financing during the observed period, the change in conditions clearly indicates a turnaround in international financial markets. While a moderation in net private capital flows, which could be exacerbated by a global economic slowdown, may be under way in 2008, the current surge in equity-related flows may give rise to new sources of vulnerability for developing countries.

11. In comparison to the financial environment prior to the East Asian crisis, emerging markets are no longer mainly exposed to short-term external debt, but rather to cross-border equity capital flows. While portfolio equity flows like FDI have been characterized as long-term investments, financial liberalization and innovation have undermined this distinction. Investors can borrow against illiquid, long-term liabilities, create liquid short-term counterparts and exit equity positions in a short period. Given that emerging markets appear to serve as a new safe haven for equity-related funds for many investors as long as high uncertainty and pessimistic prospects in developed country financial markets prevail, these developments add to the risk that emerging economies may be confronted with volatile external financing conditions and capital reversals in the near future.

12. Against a backdrop of continuing weakness in global financial markets, threats to systemic stability have intensified. Strong capital inflows and rising inflationary pressures in emerging economies, due to higher food and energy prices, are leading to expectations that policymakers in these countries will increase domestic interest

[3] Institute of International Finance, Inc., *Capital Flows to Emerging Market Economies* (Washington, D.C., 2008).

rates or allow for more currency appreciation. While these expectations could fuel more speculative inflows, they will pose policy challenges for monetary authorities, particularly in current-account deficit countries, but even in countries that have borrowed in local currencies. Moreover, cross-border carry trades, which have gained in importance in recent years, are another area of concern for emerging economies, particularly because of the risk of increased exchange rate volatility. Government authorities should proactively address misaligned incentive structures and increased financial risk in the global economy through counter-cyclical policies and prudential regulation.

C. Shortfalls in performance against official development assistance targets

13. If the commitments made at the International Conference on Financing for Development, held at Monterrey in 2002, and the G8 summit held at Gleneagles in 2005 are taken as the benchmark, official development assistance (ODA) (at constant prices) from major donors should increase by more than 60 per cent over six years from 2004 to a total of $130 billion by 2010. Half way through this period, ODA from the Organization for Economic Cooperation and Development (OECD) donors has only risen by 15 per cent. Aid to sub-Saharan Africa has increased at a faster rate, but still not fast enough to double to $50 billion in real terms by 2010, as pledged at Gleneagles.

14. The impulse for a revival in assistance from OECD countries implied by the Monterrey Consensus has been weaker in the past two years. Net ODA from OECD countries rose from $58.3 billion in 2002 to $107 billion by 2005, but has since declined to $104.4 billion in 2006 and $103.7 billion in 2007. As a proportion of donors’ gross national product (GNP), ODA from major donors dropped after inching up in 2005 to 0.33 per cent of donors’ aggregate GNP — to 0.31 per cent in 2006 and to 0.28 per cent in 2007. The average country effort stands at 0.45 per cent while only Denmark, Luxembourg, the Netherlands, Norway and Sweden have reached the United Nations target of 0.7 per cent.

15. Total aid from the United States of America, the largest donor, has doubled in real terms since 2000 and it is on track on its pledge to double aid to sub-Saharan Africa by 2010. Nevertheless, in 2007, its total net ODA declined by 9.9 per cent in real terms, which aid excluding debt relief also declined, with its ODA to GNP ratio at 0.16 per cent. The net ODA of Japan fell by 30.1 per cent in real terms in 2007, resuming a downward trend since 2000, temporarily interrupted by the 2005/06 rise in debt relief. As a result, the ODA to GNP ratio of Japan reached 0.17 per cent and the country’s declared intention to achieve an overall volume increase of $10 billion over the period 2005-2009 looks difficult to achieve.

16. In 2007, the United Kingdom of Great Britain and Northern Ireland also reduced its aid, which now stands, after debt relief is excluded, at 0.36 per cent of its national income, just half of its Gleneagles target of 0.7 per cent by 2013, although substantial increases have been programmed up to 2010/11. The decline in 2007 in the aid of France from its current 0.39 per cent share of GNP has also fallen short of its Gleneagles promise to achieve a target of 0.5 per cent of its national income by 2007 and the EU commitment of 0.51 per cent by 2010, embraced by the new Government of France.

17. Total aid from European Union (EU) member countries, accounting for 60 per cent of OECD Development Assistance Committee (DAC) ODA, fell by 5.8 per cent in real terms in 2007 to 0.40 per cent of their combined GNP. There are, however, some developments. Excluding debt relief, EU ODA increased by 8.8 per cent while net ODA from the European Commission rose by 3 per cent. Nine EU countries have increased ODA, although some still fall short of their expected minimum level as EU members or their Gleneagles promises. Germany increased its aid in 2007 by $1.9 billion, with a further increase expected in 2008, while Spain increased its net ODA by 34 per cent to $2.2 billion. Canada is keeping pace with its promise to double aid by 2010 and there has also been moderate progress by other non-G8 donors, such as Australia, Austria, Ireland and New Zealand.

18. Development cooperation by non-DAC partners has been growing strongly, even though the total volume is still small. Disbursements by these donors have been increasing in recent years, reaching an estimated $8.5 billion, or 7.5 per cent of total aid flows in 2006, of which about $7.1 billion came from other developing country contributors. Some recent studies put the latter's disbursements at around $9.2 to $11.8 billion, which would make their share in total aid flows rise to between 7.6 and 9.6 per cent as of 2006. Currently, the largest donors from the South, each providing at least $1 billion per year, are China, India, Saudi Arabia and Venezuela, and if the recent large pledges materialize, the total flows might grow to around $15 billion by 2010. The last two of these contributors from the South have achieved the target of 0.7 per cent of national income. In addition, some non-DAC countries have made substantial progress in 2007, although from a relatively small base, for example the Republic of Korea raised its aid by 43 per cent, Lithuania by 74 per cent and Latvia by 23 per cent.

19. Overall, most donors are not on track to meet their commitments to scale up aid unless they make unprecedented increases in their aid budgets. The most recent OECD survey of donors' future spending plans up to 2010, however, show that planned spending still leaves a shortfall of about $38 billion in donor budgets in 2007 dollars, if the goal of substantially increasing aid by 2010 is to be met. This is a challenge the world is facing on the eve of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus (the Doha review conference).

II. Strengthening the international financial architecture

20. In the period under review, the international community's attention was riveted on financial system weaknesses sparked by the turmoil in the sub-prime mortgage market in the United States. Efforts to craft and implement policy responses to the crisis have exposed additional policy challenges related to: improving the governance structure of the international financial institutions; strengthening the foundations of surveillance and policy cooperation on key systemic issues; exploring the role of official financing of emerging market and developing countries; and clarifying the modalities of engagement with low-income countries. These have been the focal points of recent discussions directed at strengthening the international financial system.

21. The current financial crisis highlights, once again, the multilateral aspects indispensable in building and sustaining sound financial markets. For example, at

the special high-level meeting of the Economic and Social Council with the Bretton Woods institutions, the World Trade Organization and the United Nations Conference on Trade and Development, held on 14 April 2008, the potential flaws of uncoordinated, unilateral regulatory reform were underlined in the following terms:

(a) it would imply ignoring the reality of globalized financial markets where differences in market regulation and oversight could create competitive distortions and the opportunity for costly regulatory arbitrage;

(b) the country would miss the opportunity to learn from policymakers in other parts of the world, particularly with respect to how markets work and respond under stress;

(c) financial markets reacted more favourably when authorities acted in concert.

Participants in the meeting noted that the current turmoil offered an opportunity to forge a new common approach and stressed that it was important not to let that opportunity to reform the international financial architecture slip by (A/63/80-E/2008/67, para. 41).

A. Crisis in the credit markets: policy challenges

22. Over the past several years, the combination of strong global growth, relatively low interest rates and associated stepped-up demand for riskier assets with higher yield as well as rapid financial innovation led to significant relaxation of lending standards and global under-pricing of credit risk. The correction of these accumulated weaknesses began in the spring of 2007 and, in July and August, in the context of uncertainty regarding the creditworthiness of many United States and European financial institutions, caused severe interruptions in the functioning of financial markets. Rising defaults in the United States sub-prime mortgage market provided the trigger for a widespread credit and liquidity squeeze.

23. The turmoil in global financial markets has demonstrated that increased use of newly invented risk transfer instruments in globalized markets carries a number of serious shortcomings, both in the markets themselves and in the regulatory and supervisory systems. Significant flaws in the originate-to-distribute (as opposed to the originate-to-hold) model have surfaced. In the originate-to-hold model, lenders (normally banking institutions) keep the loan assets on their balance sheets and thus have a stronger incentive to undertake rigorous credit analysis. In moving to an originate-to-distribute model, lenders (some are not banking institutions and hence not subject to regulatory oversight) package the forecasted stream of earnings from these loan assets and sell them to other investors. The creation of loans for immediate securitization and sale has reduced the incentives for originators to maintain high credit standards and adequately assess the creditworthiness of borrowers. There is a wide agreement that regulation should restore incentives for loan originators to maintain credit quality and properly incorporate risk in asset pricing.

24. Another issue related to securitization concerns the measure and concentration of risk that the banks involved in origination actually take on. The belief among market participants and regulatory agencies that the globalization of markets and

diversification of instruments would automatically spread the sharing and dispersion of risk in the financial system has proved unfounded. It has become evident that risk remained concentrated with the largest banks, especially when they had to perform on back-up lines of credit for off-balance sheet conduits or special investment vehicles during episodes of market stress. This has effectively put credit risk back on banks' balance sheets.

25. The recent market turbulence has highlighted the lack of transparency, both in the new instruments themselves and in markets more broadly. As the crisis unfolded, investors realized that they were much less informed than they had thought about the nature of the assets they had bought. The complex structure of the asset-backed instruments and the lack of transparency with regard to the underlying assets made these instruments very difficult to price, especially when market liquidity dried up under stress. There is recognition that a certain degree of standardization of securitization packages and reporting may be required, as is the case in other markets. Financial instruments need to be structured in such a way that market participants can clearly see what they are buying.

26. At the same time, concerns have increased about the lack of transparency regarding where the risks, which are widely distributed among investors all over the globe by means of securitization, reside in the financial system. For instance, the pre-Basel II banking sector reporting requirements do not allow for a full assessment of banks' exposure to structured products or of the extent to which they have to take on their balance sheets loans and liquidity commitments in the event of financial stress. Uncertainty about the location and size of potential losses has contributed significantly to elevated risk aversion, the sudden liquidity crunch and major disruptions in the money and credit markets.

27. Recent events have drawn attention to the value of credit ratings and the role of credit rating agencies in the regulatory process. As the crisis has unfolded, it has become increasingly clear that credit rating agencies' ratings for complex securities were not appropriate. The potential conflict of interest within the credit agencies' business model might also have hampered proper due diligence, particularly with regard to structured finance instruments. Investors must be discouraged from relying almost exclusively on credit ratings and must be urged to take more responsibility for their own diligent research and risk assessment.

28. In response to challenges posed by the recent market turbulence, the United States and European monetary authorities have injected unprecedented amounts of liquidity (in the case of the United States, at lowered interest rates) at various points, in many cases in a coordinated manner, to prevent the seizing up of their financial markets. Also, in February 2008, the Government of the United Kingdom was compelled to nationalize the Northern Rock bank; and, in March 2008, to prevent a much broader liquidity crisis, the United States Federal Reserve supplied term funding to facilitate the JPMorgan Chase purchase of Bear Stearns, a prominent investment bank.

29. Since the last quarter of 2007, many financial institutions in the United States and Europe have undertaken major recapitalizations to repair their balance sheets, damaged by massive losses, by obtaining cash infusions, including from sovereign wealth funds. In the short term, the most important task is to restore confidence in the financial institutions by means of realistic asset pricing, full loss disclosures and

replenishment of capital buffers, as well as through central bank liquidity operations.

30. While a process of financial rehabilitation has begun, these actions need to be reinforced by measures to address the underlying causes of the disruptions. To that end, the final report on this issue by the Financial Stability Forum[4] was presented in April 2008 and endorsed by the G7 Ministers and Central Bank Governors and the International Monetary and Financial Committee of the Board of Governors of IMF. It sets out policy recommendations on: prudential oversight of capital, liquidity and risk management; transparency, disclosure and valuation policies; the role and uses of credit ratings; the authorities' responsiveness to risks and their arrangements to deal with stress in the financial system.

31. The G7 has also identified a number of recommendations by the Financial Stability Forum considered immediate priorities for implementation before the end of summer 2008. These include prompt and robust risk disclosures; improvement of the accounting, disclosure and valuation standards for off-balance sheet entities; strengthening risk management practices, including liquidity risk management; and revision of the code of conduct for credit rating agencies.

32. The report of the Financial Stability Forum emphasizes the importance of prompt implementation of the Basel II framework, based on the argument that a new framework may help make the capital base more reflective of the changing risk profile of banks and may also serve to institute incentives for better risk measurement and management, especially in the area of securitization exposures and liquidity lines. Basel II rules require that banks disclose more information on their risk profile and the nature of such exposures than called for under Basil I. However, there is also a need for important revisions to Basel II to amplify the impact of changing market values on the financing activities of banks.

33. Meanwhile, the Basel Committee on Banking Supervision is working on several outstanding issues, including: strengthening the capital treatment of less liquid, complex, credit products and of liquidity facilities extended to support off-balance sheet vehicles; improving banks' risk management practices; and enhancing market discipline through better disclosure and valuation practices.

34. In recent years, there has been an important shift in credit intermediation to financial institutions which have not been subject to regulatory oversight. As a result, a significant share of financial market activities is beyond the focus of regulators and supervisors. Accordingly, there have been calls for such institutions that perform functions similar to those of regulated entities to be subject to comparable disclosure and regulatory requirements in order to reduce regulatory arbitrage.

35. The unprecedented liquidity injections by central banks around the world have raised the issue of appropriate and effective approaches to joint central bank interventions in global financial markets in time of systemic stress. An important point here is how to design actions to return the system to stability without undue moral hazard. Central banks have the responsibility to ensure the continued functioning of financial markets. In highly stressed financial conditions, this may

[4] "Report of the Financial Stability Forum on enhancing market and institutional resilience", 7 April 2008, available from www.fsforum.org.

require extraordinary measures. However, this involves a very delicate balancing act: overly aggressive interventions rescue careless operators, who have taken on too much risk, and will be perceived as a guarantee against failure. This will increase the risk of similar or even more severe risk-taking in the future.

36. The measures identified by the international community to strengthen the global financial system, basically confined to better disclosure, prudential controls and risk management, may not go far enough in addressing the inherent pro-cyclicality of the financial system, which tends to foster asset price bubbles. Regardless of the specific sources of disturbances, almost all episodes of systemic financial distress have at their root very rapid credit growth, excessive risk-taking and over-extension of balance sheets in good times, masked by the strength of the real economy and extraordinary increases in asset prices.

37. Recent developments have highlighted the importance of expanding the macro-prudential tools of current regulatory frameworks. The approach is to encourage the build-up of sufficiently high buffers (capital requirements) in good times, when the market price of risk falls and imbalances develop, in order both to restrain access during upswings and to provide a greater cushion against losses when disruptions occur. While financial leverage is a key ingredient of the private risk-taking necessary for investment and economic growth, it also tends to amplify both booms and downturns. By developing policy instruments to lower or raise margin or capital requirements depending on the specific situation, authorities will be able to utilize market incentives to reduce systemic risk.

38. The crisis has highlighted the importance of greater international cooperation in financial sector monitoring and regulation, which, while remaining basically national in nature, has considerable cross-border effects. It has also demonstrated the importance of better coordination and interaction among supervisors, regulators, central bankers and finance ministries within individual countries, as cooperation at the international level is only as good as cooperation at the domestic level. Efforts need to be intensified to strengthen national and international arrangements for information-sharing and to coordinate actions among the agencies responsible for supervisory oversight, provision of liquidity and bank soundness.

B. Governance reform at the Bretton Woods institutions

39. By the voting deadline of 28 April 2008, governors from 180 of 185 member countries of IMF had cast their votes on the proposed resolution on the IMF quota and voice reform package. Of these, 175 countries — representing 93 per cent of total voting power in the Fund — voted in favour of the package. Three countries voted against, two abstained and five did not vote.

40. The package includes a second round of ad hoc quota increases of close to 10 per cent, based on a new quota formula; the tripling of basic votes; and the appointment of a second Alternate Director for constituencies consisting of at least 19 members. Also, in the resolution, the Executive Board is requested to recommend further realignments of members' quota shares in the context of future general quota reviews, beginning with the fourteenth general review of quotas in 2013, to ensure that members' quota shares adequately reflect their relative positions in the world economy.

41. The new quota formula is based on updated and modernized versions of the four variables included in the old formulas — GDP, openness (the annual average of the sum of current payments and receipts), variability (the variability of current receipts and net capital flows) and official reserves. Unlike in the old formulas, purchasing power parity now plays a role in measuring gross domestic product (GDP): the GDP variable is calculated as a blend of GDP at market exchange rates and GDP at PPP rates. Also, the new formula contains a compression factor to moderate, to some extent, the role of the economy's size.

42. The realignment of quota and voting shares will lead to a net increase of 2.7 percentage points in the voting share of emerging markets and other developing countries as a whole. This very modest increase became possible only with the use of the compression factor; the application, to several emerging market and developing countries, of greater weight to the purchasing power parity GDP measure than for other countries; and, most importantly, the willingness of several advanced countries to forego part of the quota increases to which they became eligible.

43. These ad hoc adjustments indicate that the new formula per se did not achieve the stated goal of providing a simpler and more transparent means of reflecting members' relative positions in the global economy. Indeed, without these alterations, the voting shares of developing and emerging market countries would have actually declined by 1.6 percentage points.

44. The reform package recognizes the need for changes of the formula in the future. According to the Executive Board, further work is necessary on measuring trade openness; the treatment of intra-currency union flows; the method of capturing financial openness; and the measure of variability for reflecting members' potential need for Fund resources.

45. The tripling of basic votes will raise this share in total voting power from about 2 to 5.5 per cent. This move strengthens the representation of low-income countries. There is also a provision that this ratio of basic votes to total voting power will be maintained in the future. Nevertheless, the move only partly offsets the prior decline of basic votes as a share of total voting power. In the first decade of IMF, this share was as high as 11 per cent, despite its starting membership of 44, compared to the current membership of 184.

46. Quotas and voting shares are only one aspect of IMF governance. The other is the composition and size of its policymaking organ, the Executive Board, which were not addressed in the reform package. Recently, there has been a proposal for a reduction in the 24-chair Board, to 22 chairs in 2010 and 20 in 2012, that would, however, preserve the number of developing-country and emerging market-country chairs. A more balanced and a smaller Board may contribute significantly to transforming the Fund into a more effective global institution.

47. In sum, the agreed changes in members' quota and voting shares are too modest to have a significant impact on how the Fund operates. The small step forward in voting reform, taken with great difficulty and controversy, underlines the enormous political challenge confronting member countries in recasting global governance in a manner responsive to early twenty-first century realities.

48. Owing to the decline in demand for Fund resources since the late 1990s and the resulting fall in income from lending operations, the institution is currently

running a deficit. This is jeopardizing its ability to play a credible role in the international financial system. Agreement was recently reached on new expenditure and income measures. Expenditure will be reduced by 14 per cent ($100 million) in real terms over the next three years. A new income model was installed which moves away from primarily lending-based income to more predictable and sustainable investment-based sources. On 5 May 2008, the Board of Governors approved a broadening of the Fund's investment authority.

49. The World Bank has launched its own process of voice and participation reform. At its 2007 annual meeting, the Development Committee welcomed an options paper on voice and participation[5] detailing a two-stage timetable for possible actions. The proposal reflects the Bank's specificities, needs and mandates, most notably those related to the International Development Association (IDA) and the focus on poverty reduction.

50. According to the paper, the first phase would include changes in basic votes, greater representation of developing and transition country nationals in management positions, improvements in Board effectiveness and composition, selected IDA issues and special majorities. The second phase will focus on a selective capital increase, the review of the role of the IDA Board and Deputies, and the process for the selection of the President of the Bank.

51. The Development Committee also acknowledged that further consultations would be necessary to reach a political consensus. At its spring 2008 meeting, the Committee asked the Bank's Board to prepare concrete options by the 2008 annual meeting with a view to reaching consensus on a comprehensive package by the spring 2009 meeting.[6]

52. The outcome of the Fund's quota and voice reform is likely to exert a strong influence on the direction of the Bank's actions. It should be recognized, however, that the Bank has a manifestly different mandate so that, following precedents set in other development financing institutions, it can consider voting weights of at least 50 per cent for its developing country members, which are the main users of its funds.

C. Multilateral surveillance

53. Surveillance remains central to the International Monetary Fund's responsibilities in the international monetary system. The major thrust of the ongoing reform of the IMF surveillance is strengthening the analysis of macro-financial linkages, integrating multilateral perspectives into bilateral surveillance and sharpening the monitoring of financial markets. It is recognized that the Fund will need to develop new and better analytical instruments, including extension of the vulnerability exercise to advanced countries. It will also need to improve its

[5] "Voice and participation of developing and transition countries in decision-making at the World Bank. Options paper", 11 October 2007, background report prepared by the staff of the World Bank for the Development Committee meeting, available from www.worldbank.org.

[6] Communiqué of the Development Committee, the Joint Ministerial Committee of the Board of Governors of the Bank and the Fund on the transfer of real resources to developing countries, Washington, D.C., 13 April 2008, available from www.imf.org.

understanding of transmission mechanisms within global financial markets and between financial markets and the real economy.

54. One of the most important areas of the Fund’s work is surveillance over the exchange rate policies of its members. The June 2007 Executive Board updating of the 1977 surveillance decision puts exchange-rate assessment at the centre of IMF surveillance. However, there exists a wide variance in views of the concept of misalignment. Some experts even contend that estimating the amount of currency over- and undervaluation is not at all possible. The results of calculations are very sensitive to various assumptions. The problem is that even information drawn from a variety of models will not provide a definitive answer and must be supplemented by assessments based on additional considerations regarding other causes behind the exchange rates’ deviations from calculated ostensible equilibrium values. Hence, given the considerable uncertainties and the subjective nature of misalignment estimates, these results could hardly serve as the basis for assessing countries’ policies.

55. Implementation of the new decision can impose undue pressure on developing and emerging market countries pursuing export-led growth strategies, which in turn require maintenance of the long-run stability of competitive real exchange rates. Because many of these countries have open capital accounts subject to volatile flows, they often have to resort to policies that prevent excessive appreciation of their exchange rates. Moreover, more rigorous surveillance over systemically important countries issuing major reserve currencies is not likely, since the decision does not differentiate among countries in terms of their influence on systemic stability. This is at variance with the intended “even-handedness” of the new decision.

56. Owing to lack of consensus on many important issues, implementation of the 2007 decision on surveillance over members’ exchange rate policies remains a work in progress. The prompt adoption of clear and detailed implementation guidelines acceptable to all members with different exchange-rate arrangements is critical.

57. In addition to the new surveillance decision, the IMF Executive Board reached an agreement on a “Statement of surveillance priorities” in the context of the 2008 triennial surveillance review. The fundamental goal of this effort should be to strengthen the spirit of cooperation by reaching a consensus among all members on the role of surveillance in helping Governments deal with the challenges of the integrated global economy.

58. The series of substantial equity contributions to troubled financial institutions in industrial economies has caused the sudden visibility of sovereign wealth funds from developing countries and numerous calls for the regulation of their activities. The International Working Group of Sovereign Wealth Funds, comprised of representatives of 25 IMF member countries, was established at a meeting held at the IMF headquarters in May 2008. The Group aims to agree on and present by October 2008 a common set of voluntary best practices for sovereign wealth funds. OECD has undertaken parallel work in drawing up a similar set of guidelines for recipient countries. The stated goal of both exercises is to forestall the risk of investment protectionism and to help maintain the free flow of cross-border investment as well as open and stable financial systems. It is important that the guidelines for sovereign wealth funds are not more onerous than for other large

institutional investors and do not introduce an element of bias and lack of even-handedness in financial surveillance.

D. Financing in times of crisis and for crisis prevention

59. The onset of the food crisis has reignited interest in mechanisms to protect developing countries, particularly low-income countries, from external economic shocks. Existing compensatory facilities do not provide sufficient resources relative to the shock and have high levels of conditionality, which limits their effectiveness for events beyond the control of affected countries. Countries have responded to shocks either by non-concessional borrowing or by tightening fiscal and monetary policy, thereby undermining their own reform processes in order to avoid the onerous conditionalities associated with existing facilities.

60. Heavy dependence on commodity exports is strongly associated with the external debt problem of developing countries. When international prices decline, commodity-dependent exporters have borrowed to pay for needed imports and to help finance domestic investment. The variability of commodity prices makes countries that are highly dependent on commodities unable to plan effectively on the basis of predictable income streams. It also makes them susceptible to terms-of-trade shocks that introduce high levels of uncertainty to their balance of payments and (indirectly) also have an impact on their fiscal positions, growth and poverty.

61. Protecting economic growth from commodity price changes in a manner which does not introduce debt vulnerabilities has long been a financing-for-development issue. In the long run, diversifying out of commodity export dependence into manufactured exports is the solution. In the short-run, the build-up of reserves during episodes of high prices to ride out the periods of price slumps is necessary. When there are insufficient reserves to address price declines, financing responses have to be consistent with the nature of the shock.

62. At the spring 2008 meeting, the Development Committee requested the Fund and the Bank to be ready to provide timely policy and financial support to vulnerable countries dealing with negative shocks, including from food prices.[7] Since early 2007, food prices have risen by close to 50 per cent. While supply-side factors vary, strong global demand, originating from fast-growing emerging economies, has been a decisive factor. Higher oil prices have also contributed by increasing production and distribution costs as well as the new demand for bio-fuel production. Portfolio speculation has played an increasing role in day-to-day movements of commodity prices. Continued demand pressures and lagging supply are expected to keep prices at high and possibly rising levels for quite some time.

63. Higher food prices would have serious negative consequences for least developed countries, particularly for net food importers. Most poor households in developing countries, especially the urban poor who are net food buyers, would be adversely affected. According to United Nations estimates, the surge in global food prices since 2006 has put an additional 109 million people at risk of falling under the $1 a day poverty line, with Africa being hardest hit.

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[7] Communiqué of the Development Committee, the Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the transfer of real resources to developing countries, Washington, D.C., 13 April 2008, available from www.imf.org.

64. In June 2008, IMF doubled financial assistance to four low-income countries affected by food and fuel price hikes to cover rising import costs and was discussing additional support for another 11 countries. These are all countries already under IMF programmes.

65. While it is recognized that policy responses to higher food prices have to be tailored to the needs of each country, social assistance targeted at the most vulnerable groups is considered an important initial policy. Also, temporary tax and tariff cuts on food products could be used as supporting measures. Some countries have undertaken price and export controls to secure domestic supply and control consumer prices. Many observers have commented on these policies' potential to limit the availability of goods, thus creating further price increases at the regional and global level. Given that most developing countries are net food importers, these policies would be appropriate as short-term responses.

66. The World Bank announced on 29 May 2008 that it would support global efforts to overcome the global food crisis with a new $1.2 billion rapid financing facility to address immediate needs, including $200 million in grants targeted at the vulnerable in the world's poorest countries.

67. The Compensatory Financing Facility was a major IMF facility until 2000 when the programme was reviewed and amended. Since that time, IMF has provided liquidity for trade shocks for countries under the Poverty Reduction and Growth Facility. Even though it is concessional financing, it is not available to countries not part of the Poverty Reduction and Growth Facility and its financing is accessed under the conditionality of such a facility. The size of the financing has been found to be small in comparison to the shock. IMF created a new window, called the Exogenous Shocks Facility, at concessional rates for low-income countries facing exogenous shocks. It applies only to export, not import, price shocks, and would therefore not be available to countries facing higher import payments. It is viewed as a high-conditionality form of financing since it requires agreement on a programme (called the Policy Support Instrument) which effectively involves conforming to policies normally part of IMF programmes. When a shock occurs, adjustments to the Policy Support Instrument can be negotiated to trigger the Exogenous Shocks Facility financing. In fact, the Policy Support Instrument is suspended the moment an Exogenous Shocks Facility is approved. Exogenous Shocks Facility financing is limited to 25 per cent of quota. No country has used the Exogenous Shocks Facility.

68. Middle-income countries, particularly those with open capital accounts, have a specific interest in international facilities for responding to exogenous liquidity shocks. Emerging economies have made significant progress in improving their economic fundamentals and policymaking, and some have accumulated significant reserves. However, in the face of an exogenous stoppage in external funding, their domestic central banks are unable to inject sufficient liquidity in the form of domestic currency, since this will not only be inflationary, but can cause the domestic currency to depreciate and/or the domestic interest rates to rise considerably. Also, there is no guarantee that during a major capital reversal or global liquidity crunch domestic central banks will have sufficient reserves to provide emergency liquidity assistance in foreign exchange.

69. For these countries, IMF, along with regional reserve pooling arrangements, can potentially be an international lender of last resort. In this regard, there have

been proposals to increase normal access limits significantly above the current 300 per cent of quotas. Over the past 10 years, access limits — as a share of GDP, trade and capital flows — have declined for emerging market and developing countries. This has led to a more or less permanent need to provide exceptional access, with exceptional financial and political costs, for countries experiencing capital reversals. Despite the quota and voice reform package, the limits for non-exceptional access are likely to continue to shrink further in relation to members' potential needs. Accordingly, there is a view that quotas are not an appropriate measure on which to base access to Fund resources and that alternative measures should be explored.

70. In addition to increased normal access, there have been suggestions that the possibility be examined of providing the Fund with mechanisms for short- or very short-term loans to be granted rapidly to member countries affected by sudden international liquidity crunches. When a systemic financial crisis occurs, speed is critical for the restoration of confidence in the financial system. The faster the lending, the less the amount of money needed. The creation within the Fund of instruments for quick provision of liquidity, similar to those used by central banks of advanced economies to cope with the current turbulence, may be worth studying.

71. The Fund has been developing a new liquidity instrument, the Rapid Access Line, to meet the needs of developing and emerging market countries. Despite some support for the Rapid Access Line, there is still no consensus among Fund members regarding the costs and conditions associated with accessing the proposed facility.

E. Financing gender equality

72. In taking up the theme of "Financing gender equality", the Commission on the Status of Women, at its fifty-second session, held in New York in February and March 2008, expressed concern that insufficient political commitment and budgetary resources posed obstacles to promoting gender equality and women's empowerment, and continued to undermine the effectiveness and sustainability of both national mechanisms for the advancement of women and women's organizations in advocating for, implementing, supporting and monitoring the effective implementation of the Beijing Declaration and Platform for Action and the outcome of the twenty-third special session of the General Assembly. The Commission also expressed its concern about the growing feminization of poverty and called for the assignment of sufficient resources for gender equality and the empowerment of women and girls.

73. The Commission called for the scaling up of investment in gender equality and women's empowerment, including through mainstreaming a gender perspective in resource allocation and by ensuring the necessary resources for targeted activities for gender equality. It also recommended ways of ensuring resource allocation for economic policy and public finance management, specifically noting that national plans for promoting gender equality should be costed and their implementation adequately resourced.

74. The Commission identified the importance of developing and implementing methodologies and tools, including national indicators, for gender-responsive planning and budgeting in order to systematically incorporate gender perspectives into budgetary policies at all levels, with a view to promoting gender equality in all policy areas. The Commission called on Governments to identify and implement

development-oriented and durable solutions that integrated a gender perspective into the external debt and debt-servicing problems of developing countries, including least developed countries, inter alia, through debt relief, including the option of debt cancellation under official development assistance, in order to help them finance programmes and projects targeted at development, including the advancement of women.

III. Conclusions

75. **Both national and international prudential regulatory frameworks need to give more effective attention to the systemic components of risk build-up in financial markets, with particular focus on the inherent pro-cyclicality of financial markets.**

76. **In the context of integrated global markets, a cooperative and multilaterally coordinated approach to regulatory reform in the financial sector is indispensable.**

77. **The ongoing reform of the governance structures of the international financial institutions, which all parties agree are critical to the integrity of the international financial system, has taken only small first steps, and efforts in that regard should be intensified.**

78. **In terms of global financial stability, it is vital to reach, in a cooperative manner, a consensus on the role of IMF surveillance and its key responsibilities in the international financial system.**

79. **The international community should expand and strengthen instruments to support low-income countries facing sharp rises in food and energy prices.**

80. **In order to achieve the goal of reducing poverty, increased financing for gender equality should be a key feature of the financing for development process.**

Annex

Net transfer of financial resources to developing economies and economies in transition, 1996-2008

(Billions of United States dollars)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*[a]
Developing economies	21.3	-3.5	-37.2	-118.9	-185.5	-153.9	-202.9	-295.1	-365.8	-562.3	-734.9	-792.3	-895.3
Africa	-8.3	-6.9	13.1	2.5	-31.4	-16.6	-5.0	-19.4	-36.1	-65.1	-77.8	-61.6	-105.1
Sub-Saharan (excluding Nigeria and South Africa)	5.2	7.1	12.0	9.1	3.0	7.2	4.6	5.9	2.7	-0.1	-6.9	-4.5	-15.2
Eastern and Southern Asia	19.3	-31.0	-127.9	-137.2	-119.8	-115.9	-144.4	-169.3	-175.5	-252.3	-372.8	-470.8	-458.7
Western Asia	10.8	11.8	34.5	6.7	-31.4	-24.4	-19.7	-43.9	-70.5	-136.3	-153.4	-158.3	-256.5
Latin America	-0.5	22.5	43.1	9.1	-2.9	3.0	-33.7	-62.5	-83.7	-108.6	-130.8	-101.5	-75.1
Economies in transition	-8.7	1.6	0.7	-25.1	-51.5	-33.3	-28.6	-39.0	-63.3	-100.8	-124.9	-100.4	-127.5
Memorandum item:													
Heavily indebted poor countries	6.8	7.2	8.5	10.6	8.2	8.9	10.6	10.2	10.5	14.3	12.9	21.1	25.7
Least developed countries	11.7	10.4	13.7	11.7	6.8	9.9	7.9	9.3	6.2	4.7	-2.7	-1.4	-8.1

Source: Department of Economic and Social Affairs of the United Nations, based on IMF, World Economic Outlook Database, April 2008 and IMF, Balance of Payments Statistics.

Note: The developing countries category does not include economies in transition; hence, data in this table may differ from those reported for country groupings in the IMF sources.

[a] Estimates.