First session of the Preparatory Committee for the fourth International Conference on Financing for Development

Multi-Stakeholder Round Table Discussion on "Addressing Systemic Issues"

Wednesday, 24 July 2024, 16:30 – 18:00

Issue note

Background

The Addis Ababa Action Agenda (Addis Agenda) emphasizes the importance of the coherence and consistency of the international financial, monetary and trading systems, integrating economic, social, and environmental dimensions. It reflects the continued risks and vulnerabilities in the international financial system and calls for reforms to the institutional structures and governance of the international financial architecture. The recent global crises have further highlighted that the current international financial architecture is not fit for purpose in a world characterized by increasing systemic risks, including climate change, extreme inequality, highly integrated financial markets vulnerable to cross-border contagion, and dramatic demographic, technological and geopolitical changes. The decision to organize the fourth conference explicitly calls for the conference "to support reform of the international financial architecture."

The Addis Ababa Action Agenda focuses on commitments and initiatives to:

i) enhance global economic governance
The Addis Agenda commits to broadening and strengthening the voice and participation of developing countries in international economic decision-making and norm-setting, including in the International Monetary Fund (IMF), the World Bank and financial norm-setting bodies. This includes reforms at the IMF and the World Bank to reflect changes in the global economy and enhance the representation of developing countries. It also includes a commitment to open and transparent, gender-balanced and merit-based selection of the heads of the international financial institutions, and to enhanced diversity of staff. Member States also emphasized the need to strengthen the United Nations' role in promoting universal and holistic coherence and international commitments to sustainable development.

ii) *enhance macroeconomic stability and strengthen the global financial safety net*
To enhance macroeconomic stability, the Addis Agenda emphasizes the importance of strengthening the global financial safety net and maintaining a strong, quota-based IMF with adequate resources to fulfill its systemic responsibilities. It calls for enhanced cooperation between the IMF and regional financial arrangements to improve early warning systems for macroeconomic and financial risks and to provide more comprehensive and flexible financial responses to the needs of developing countries. It also highlights that volatile capital flows can be dealt with through both macroeconomic adjustment and capital flow management measures. Member States also looked forward to undertaking the special drawing rights (SDRs) review.

iii) *improve financial regulation*

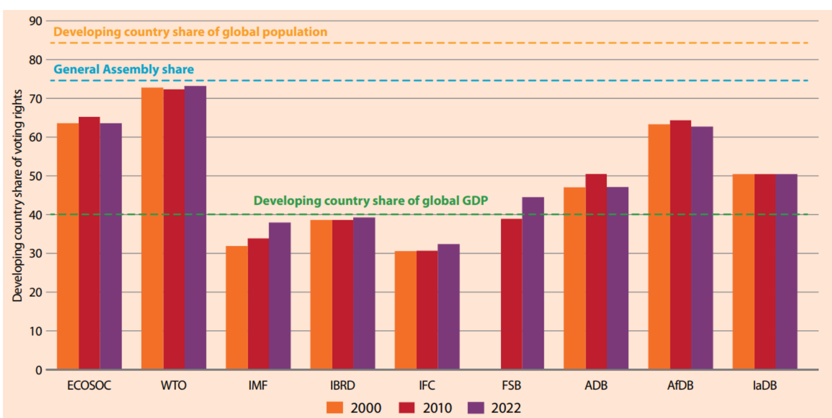
Repeated financial crises highlight the need for sound regulation of financial markets to enhance financial and economic stability. The Addis Agenda calls for stronger national financial regulation to build resilience and reduce international spillovers from financial disruptions, addressing banks, non-bank financial institutions, and financial markets. Acknowledging volatility of commodity prices, Member States commit to ensure the proper functioning of food commodity markets and their derivatives. They also pledge to reduce mechanistic reliance on credit-rating agency assessments, improve the quality of ratings, and promote increased integrity and transparency in the provision of credit ratings.

The Addis Agenda also stresses the importance of ensuring that international agreements, rules and standards are consistent with each other and with progress towards the SDGs, and encourages development finance institutions to align their business practices with the 2030 Agenda for Sustainable Development.

How have we done?

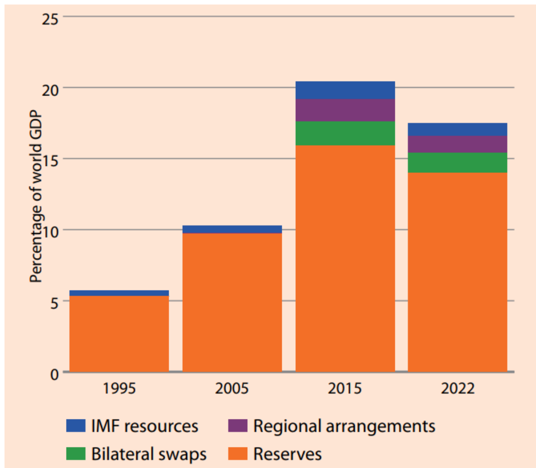
Developing countries' representation in many international financial institutions, regional development banks and standard-setting bodies has not changed significantly, though there have been some improvements since 2000 (figure 1). After gains following the 2008 world financial and economic crisis, several international standard-setting bodies have experienced stagnant or declining representation of developing countries on their principal decision-making organs in recent years. The largest developed countries continue to hold de facto veto powers in the decision-making bodies of international financial institutions.

Figure 1. Developing country share of voting rights, select institutions, 2000-2022 *(Percentage)*



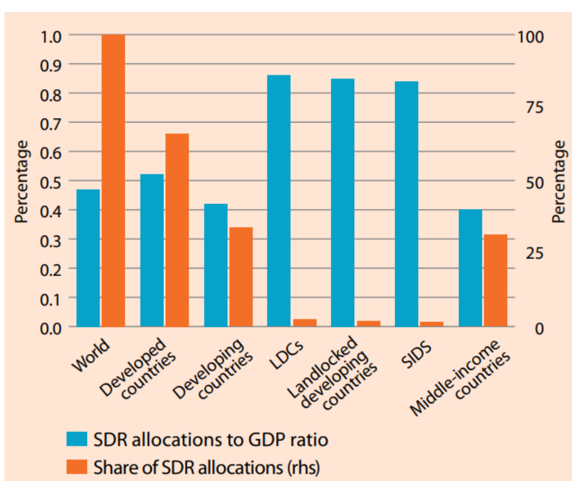
The global financial safety net has grown to over 17.6 per cent of world GDP (figure 2). Countries' gross reserves are by far the largest component of the global financial safety net. Since 2000, the total stock of international reserve holdings has increased more than six times, reaching US$14 trillion at end-2022, while the size of external resources available through other safety net layers grew nearly 16 times, to around $3.5 trillion.

Figure 2. Global financial safety net size and composition, 1995–2022 *(Percent of world gross product)*



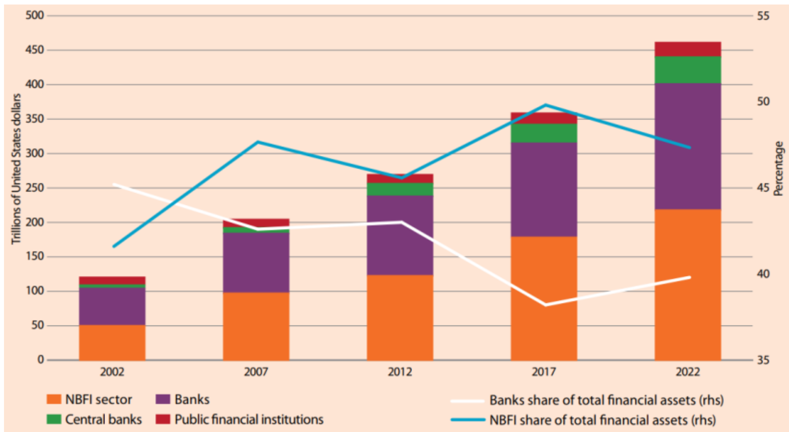
The safety net was bolstered by the 2021 allocation of $650 billion worth of SDRs aimed at supporting countries in navigating the economic fallout of the COVID-19 pandemic. Developing countries received around one-third of the allocation, which represented 0.42 per cent of their GDP (figure 3). Developing are the main users of SDRs, while developed countries tend to hold them as part of central bank reserves.

Figure 3. 2021 SDR allocation, by country group (*SDR allocations to GDP ratio and share of SDR allocation*)



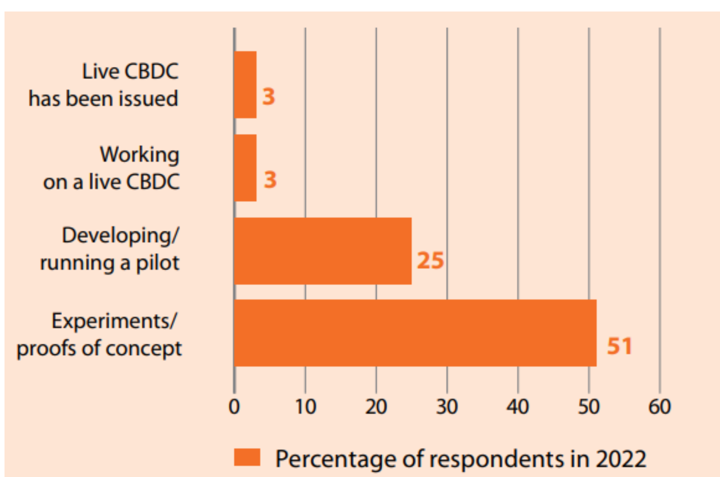
Non-bank financial intermediation (NBFI), also known as shadow banking, has grown to almost $218 trillion, almost half of global financial assets (figure 4). As a result, the importance of NBFIs for the financing of the real economy has increased. Non-bank financial institutions have also increasingly taken on the provision of credit to developing countries, accentuating procyclicality.

Figure 4. Total global financial assets broken down by type of financial institution, 2002-2022 *(Trillions of United States dollars, percentage of assets)*



Ninety-three per cent of central banks were engaged in some form of central bank digital currencies (CBDCs) work, and almost a quarter of central banks are piloting a retail CBDC (figure 5). A few CBDCs have already been launched. CBDC issuance has the potential to enhance payments efficiency, but it could introduce new risks, including macro risks such as currency substitution.

Figure 5. Status of CBDC work by central banks, 2018-2022 *(Percentage of respondents)*



Actions and Challenges

There is broad recognition of the need to better align global financial and monetary systems with the Sustainable Development Goals (SDGs) and increase coherence. The lack of coherence and coordination in the system has often resulted in disjointed responses to economic, financial and other crises. Calls for reforming the international financial architecture to enhance policy coherence and coordination have gained momentum, with Member States endorsing such reforms in various forums, including in the United Nations.

Enhancing global economic governance

Legitimate and effective global economic governance can be viewed as a global public good, with the collective value provided by legitimate arrangements far outstripping the collective costs. Repeated commitments to increase the voice and representation of developing countries in global economic governance were made in the United Nations and by the governing bodies of the international financial institutions. Some improvements to increase developing country voice and representation were made between 2005 and 2015, but the pace and scale of change has not been in line with changes in the global economy and there have been only minimal changes since 2015. Creating more coherent, democratic and representative global economic governance remains a challenge, especially since voting rights reforms can be viewed as zero-sum, and past commitments to reforms have proved insufficient to generate political will for changes.

Macroeconomic stability and the global financial safety net

The global financial safety net, a multilayered arrangement for responding to crises with the International Monetary Fund (IMF) at its centre, has come under strain in recent years, revealing both gaps in the architecture and uneven coverage, despite some enhancements since 2015.

Regional financing arrangements continue to play a limited role in the global financial safety net. Bilateral swap arrangements among central banks have become more prevalent, providing additional layers of liquidity during times of financial stress – for those countries with access – and helping to stabilize financial markets. However, only a small volume of resources is available to most developing countries.

SDRs were successfully allocated twice in crisis situations in the last 20 years, but the mechanism for allocating SDRs in proportion to countries' IMF quota shares means that developing countries received only around one third of the 2021 SDR allocation. In the wake of the 2021 allocation, some IMF members with sufficient reserves and strong external positions agreed to voluntary rechannel SDRs to countries that need them, with over $100 billion been pledged mainly to the IMF's Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust (RST). Given that many of the SDRs on central bank balance sheets in developed countries are unused, there have been calls for more rechannelling, including to multilateral development banks.

The expansion of the IMF's Catastrophe Containment and Relief Trust (CCRT) provided debt service relief to countries during the pandemic. The RST, created in 2022 and funded in part by the SDRs of G20 countries, provides longer-term lending through an associated facility for low-income and vulnerable middle-income countries. In 2023, a 50 per cent quota increase at the IMF also increased the volume of quota-based resources available to the Fund, but not it's overall resource availability.

The volatility of capital flows continues to pose significant risks to financial stability in developing countries. Monetary and financial policies in major developed countries have significant spillover effects on developing countries, with the recent rise in developed country interest rates to contain inflation resulting in a reduction in liquidity and increase in borrowing costs for developing countries. Countries that accumulated large reserves to cushion against such shocks face high opportunity costs in terms of forgone investments in sustainable development as foreign reserves could instead be invested in health, education, and infrastructure.

Financial regulation

Significant efforts have been made to strengthen financial market regulations. Enhanced global regulatory standards were agreed to improve the resilience of financial institutions and markets. These include stricter capital and liquidity requirements for banks and more robust oversight of some financial activities. The Basel III framework has been widely adopted in G20 countries, enhancing the stability of banking systems, with the Financial Stability Board (FSB) coordinating efforts of those countries to promote global financial stability through the development and implementation of effective regulatory, supervisory, and other financial sector policies.

There has been growing recognition of the need to integrate climate-related risks into financial regulation and supervision. Some countries have begun to incorporate climate risk assessments into their regulatory frameworks, aiming to align financial markets with sustainable development goals. New initiatives like the Network for Greening the Financial System (NGFS) have helped guide central banks and supervisors on managing climate risks. Initiatives to improve the availability of market information and regulations in some jurisdictions on commodity derivatives trading have helped allay some of the risks of excessive commodity price volatility.

Despite progress, the implementation of regulatory reforms remains uneven across countries. Recent bank failures show that financial sector stability remains a challenge despite progress, along with industry pressures to roll back the implementation of stricter standards. Additionally, certain financial activities and institutions, such as non-bank financial intermediaries, remain underregulated. Uneven implementation of standards can lead to regulatory arbitrage, where financial activities move to less regulated areas, potentially undermining financial stability. In many developing countries, regulatory capacities are also limited, leaving gaps in oversight and enforcement.

Financial regulation must aim to address systemic risks to financial stability from all sources, including disasters and the impacts of climate change. At the same time, all regulation creates incentives; as noted in the Addis Agenda, unintended consequences of regulation on inclusive finance and implementation of the SDGs should continue to be monitored.

Commodity price volatility remains a challenge, with the recent crises exacerbating price volatility for some essential food commodities. New risks have also emerged, including those associated with the rapid evolution of digital financial instruments and cryptoassets. The decentralized nature of some new technologies may allow cross-border transactions to bypass financial supervision.

The way forward and guiding questions for discussion

Following the unprecedented systemic shocks of recent years, numerous solutions have been proposed to tackle persistent challenges related to i) global economic governance; ii) macroeconomic stability and the global financial safety net and iii) financial regulation.

In terms of global governance, governments can consider complementary reforms to decision making rules, board structures, transparency, senior management selection processes. Efforts can also be made to link access to resources to needs and vulnerabilities instead of voting rights. To further strengthen the global financial safety, reforms related to the role and use of SDRs, additional flexibilities in IMF lending, multilateral currency swap facilities and strengthening regional financial arrangements have been suggested. A larger role for the SDR in buffering external adjustment or providing a flexible source of finance to bolster IMF lending capacity would require revisions to the IMF Articles of Agreement, although the IMF executive board could on its own agree to triggers that automatically generate a recommendation for SDR issuance, or to standing arrangements to rechannel SDRs on issuance. Continuing tests to financial sector stability have led to calls for more coherent regulation of different market participants, addressing short-term incentives and better aligning market regulations, standards, and practices with the SDGs.

1. Global economic governance

- What measures can be taken to accelerate governance reform of international financial institutions to increase the voice and representation of developing countries?
- How can the international community enhance coordination and coherence among different institutions and frameworks to create a more resilient and inclusive international financial architecture?

2. Macroeconomic stability and the global financial safety net

- How can the global financial safety net be further strengthened to provide more equitable and effective liquidity support to developing countries in accordance with their needs?
- What measure can be taken to ensure access to liquidity support that are better linked

to needs and vulnerability?

- What reforms are needed to the international monetary and financial systems to reduce volatility and provide a stable global macroeconomic environment that is conducive to sustainable development?

3. Financial regulation

- What strategies can be implemented to address regulatory gaps and supervisory lapses and enhance the implementation of financial market reforms best adapted to countries' needs?
- How can regulators, supervisors and central banks better integrate climate-related risks and impacts into their rule- and decision-making processes?
- What concrete actions can be taken to monitor and address the unintended consequences of regulation and effectively balance incentives with financial stability considerations?