

Chapter III

Financial flows to developing countries

Net resource transfers from poor to rich countries

Developing countries as a group are expected to have continued to provide net financial resources to developed countries in 2009 at a level of \$568 billion. While still substantial, this amount is notably lower than the all-time high of \$891 billion reached in 2008 (table III.1). The forecast reduction reflects the tentative narrowing of the global imbalances as a consequence of the ongoing global economic and financial crisis. The structure of flows underlying the substantial negative financial transfers in 2008 and those preliminarily estimated for 2009 indicates that, for the most part, a disorderly unwinding of accumulated global imbalances is under way, a prospect the *World Economic Situation and Prospects (WESP)* has been flagging in recent issues.

The ongoing global financial crisis affected net financial transfers from developing countries in all regions of the developing world in 2009. Western Asia experienced the strongest decline in net resource flows, driven in particular by much lower oil prices and also by countries in the region having to draw on international reserves to compensate for the fall in external demand. Latin America and the Caribbean experienced lower outward investment on a net basis as the value of their export earnings declined in line with the contraction of world trade in goods. East and South Asia are the only regions where,

Net resource transfers from poor to rich countries remain high despite a decline resulting from the global contraction of output and employment

Only East and South Asia saw an increase in negative net transfers

Table III.1

Net transfer of financial resources^a to developing economies and economies in transition, 1997-2009

| Billions of dollars | | | | | | | | | | | | | |
|---|-------------|--------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|-------------------|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 ^b |
| Developing economies | -3.6 | -37.1 | -126.2 | -195.0 | -163.8 | -208.2 | -302.3 | -378.0 | -581.0 | -781.9 | -870.3 | -890.7 | -567.7 |
| Africa | -7.0 | 13.0 | 1.5 | -32.2 | -16.8 | -5.1 | -19.0 | -35.4 | -63.9 | -87.2 | -98.7 | -91.4 | 20.8 |
| Sub-Saharan Africa (excluding Nigeria and South Africa) | 7.4 | 12.2 | 8.5 | 2.6 | 6.8 | 4.8 | 6.5 | 4.1 | 0.8 | -9.6 | -5.6 | -1.0 | 27.3 |
| East and South Asia | -32.1 | -128.2 | -139.4 | -124.8 | -121.0 | -147.7 | -173.5 | -181.1 | -262.5 | -383.6 | -518.4 | -478.9 | -497.2 |
| Western Asia | 12.4 | 34.5 | 2.7 | -35.3 | -29.7 | -23.2 | -46.7 | -76.9 | -145.4 | -175.8 | -150.0 | -259.5 | -52.4 |
| Latin America and the Caribbean | 23.2 | 43.7 | 8.9 | -2.8 | 3.7 | -32.2 | -63.2 | -84.6 | -109.3 | -135.4 | -103.2 | -60.9 | -38.8 |
| Economies in transition | 1.6 | 0.7 | -25.1 | -51.5 | -32.9 | -27.9 | -38.0 | -62.4 | -95.7 | -117.1 | -98.3 | -153.0 | -89.7 |
| Memorandum items: | | | | | | | | | | | | | |
| Heavily indebted poor countries (HIPCs) | 7.2 | 8.4 | 9.8 | 8.5 | 8.5 | 10.9 | 13.1 | 15.6 | 20.4 | 18.6 | 28.0 | 43.4 | 45.7 |
| Least developed countries ^c | 10.3 | 13.6 | 11.4 | 6.2 | 9.1 | 7.3 | 8.9 | 6.0 | 2.9 | -7.4 | -4.9 | -0.7 | 20.3 |

Sources: UN/DESA, based on IMF, World Economic Outlook Database, October 2009; and IMF, Balance of Payments Statistics.

^a Net financial transfers are defined as net capital inflows less interest and other investment income payments abroad.

^b Partly estimated.

^c Cape Verde graduated in December 2007 and is not included in the calculations.

in the aggregate, negative net transfers increased moderately in 2009. Despite a narrowing of current-account surpluses, reserve accumulation has resumed at a strong pace. Net transfers from countries with economies in transition decreased from \$153 billion in 2008 to \$90 billion in 2009, owing mainly to the economic downturn in the Russian Federation, where the sharp decline in commodity prices and the pronounced reduction in global demand for manufactured goods in the first half of 2009 required strong government intervention in the form of counter-cyclical fiscal measures.

The fall in exports creates severe problems in developing countries

In developing countries, the drastic downward adjustment of export sectors is imposing severe and potentially long-lasting hardships on women and the poor. Significant declines in public sector revenues in developing countries as a consequence of the fall in exports are setting off fiscal deficits and new pressures to borrow, thus increasing the prospect of a resurgence of debt-servicing defaults farther down the road. Since private flows are highly cyclical, foreign direct investment (FDI) and portfolio flows to developing countries have fallen sharply from a net value of \$403 billion in 2007 to \$71 billion in 2008 (table III.2).

Table III.2
Net financial flows to developing countries and economies in transition, 1996-2010

| Billions of dollars | | | | | | | |
|---------------------------------------|---------------------|-----------|--------|----------|--------|-------------------|-------------------|
| | Average annual flow | | 2006 | 2007 | 2008 | 2009 ^a | 2010 ^b |
| | 1996-1999 | 2000-2005 | | | | | |
| Developing Countries | | | | | | | |
| Net private capital flows | 120.1 | 109.1 | 104.4 | 403.0 | 70.6 | 54.7 | -30.0 |
| Net direct investment | 130.6 | 156.5 | 196.2 | 309.3 | 323.1 | 233.7 | 209.5 |
| Net portfolio investment ^c | 49.6 | -32.4 | -96.8 | 20.8 | -132.8 | -128.2 | -215.2 |
| Other net investment ^d | -60.1 | -15.1 | 5.0 | 72.9 | -119.7 | -50.7 | -24.2 |
| Net official flows | 16.4 | -37.0 | -126.5 | -121.9 | -118.0 | -21.5 | -65.6 |
| Total net flows | 136.5 | 72.1 | -22.1 | 281.1 | -47.5 | 33.1 | -95.6 |
| Change in reserves ^e | -73.5 | -274.6 | -615.8 | -1 073.1 | -733.5 | -474.5 | -513.7 |
| Africa | | | | | | | |
| Net private capital flows | 5.3 | 8.2 | 7.7 | 25.1 | 15.3 | 21.5 | 48.1 |
| Net direct investment | 7.0 | 19.7 | 27.7 | 42.8 | 52.2 | 34.5 | 40.8 |
| Net portfolio investment ^c | 2.8 | 1.1 | 17.3 | 12.1 | -34.1 | -8.4 | 5.0 |
| Other net investment ^d | -4.6 | -12.6 | -37.4 | -29.8 | -2.8 | -4.6 | 2.3 |
| Net official flows | 3.0 | 4.3 | 8.2 | 6.3 | 4.6 | 14.6 | 14.9 |
| Total net flows | 8.3 | 12.5 | 15.8 | 31.4 | 19.9 | 36.1 | 63.0 |
| Change in reserves ^e | -6.8 | -24.7 | -77.6 | -86.9 | -76.4 | 11.8 | -35.3 |
| East and South Asia | | | | | | | |
| Net private capital flows | 30.3 | 65.6 | 33.2 | 160.8 | -7.7 | -36.4 | -157.6 |
| Net direct investment | 60.7 | 68.5 | 93.6 | 132.7 | 138.1 | 88.3 | 58.2 |
| Net portfolio investment ^c | 25.5 | -12.7 | -109.1 | 8.1 | -68.2 | -114.7 | -223.0 |
| Other net investment ^d | -55.9 | 9.8 | 48.7 | 20.0 | -77.6 | -9.9 | 7.2 |
| Net official flows | 3.1 | -17.1 | -20.9 | -47.7 | -25.1 | -19.3 | -20.5 |
| Total net flows | 33.4 | 48.5 | 12.3 | 113.1 | -32.8 | -55.7 | -178.1 |
| Change in reserves ^e | -55.3 | -202.7 | -384.5 | -688.3 | -464.5 | -429.3 | -377.4 |

| Table III.2 (cont'd) | | | | | | | |
|--|---------------------|-----------|--------|--------|--------|-------------------|-------------------|
| | Average annual flow | | 2006 | 2007 | 2008 | 2009 ^a | 2010 ^b |
| | 1996-1999 | 2000-2005 | | | | | |
| Western Asia | | | | | | | |
| Net private capital flows | 16.5 | 2.6 | 26.7 | 104.9 | -4.0 | 44.7 | 39.1 |
| Net direct investment | 6.3 | 12.8 | 45.4 | 47.2 | 42.3 | 39.7 | 40.5 |
| Net portfolio investment ^c | -0.8 | -11.0 | -16.5 | -37.7 | -9.9 | 11.4 | -2.2 |
| Other net investment ^d | 11.0 | 0.7 | -2.2 | 95.4 | -36.4 | -6.5 | 0.8 |
| Net official flows | 2.3 | -22.7 | -70.2 | -79.6 | -101.1 | -44.2 | -67.6 |
| Total net flows | 18.8 | -20.2 | -43.5 | 25.3 | -105.0 | 0.5 | -28.5 |
| Change in reserves ^e | -8.5 | -31.7 | -103.4 | -164.8 | -141.2 | -37.7 | -83.0 |
| Latin America and the Caribbean | | | | | | | |
| Net private capital flows | 68.0 | 32.7 | 36.9 | 112.2 | 67.0 | 24.8 | 40.4 |
| Net direct investment | 56.5 | 55.5 | 29.5 | 86.6 | 90.4 | 71.1 | 70.1 |
| Net portfolio investment ^c | 22.1 | -9.7 | 11.5 | 38.4 | -20.6 | -16.5 | 4.9 |
| Other net investment ^d | -10.6 | -13.0 | -4.1 | -12.8 | -2.9 | -29.7 | -34.6 |
| Net official flows | 8.0 | -1.5 | -43.6 | -0.9 | 3.6 | 27.5 | 7.6 |
| Total net flows | 76.0 | 31.2 | -6.8 | 111.3 | 70.5 | 52.3 | 48.0 |
| Change in reserves ^e | -2.9 | -15.4 | -50.3 | -133.1 | -51.5 | -19.3 | -18.1 |
| Economies in transition | | | | | | | |
| Net private capital flows | 1.6 | 12.6 | 73.4 | 142.5 | -79.6 | -90.3 | -9.9 |
| Net direct investment | 6.2 | 9.9 | 30.6 | 39.1 | 58.9 | 22.6 | 31.9 |
| Net portfolio investment ^c | 1.3 | -0.1 | 12.6 | 16.8 | -32.4 | 2.6 | 6.6 |
| Other net investment ^d | -6.0 | 2.8 | 30.2 | 86.5 | -106.1 | -115.6 | -48.4 |
| Net official flows | -6.7 | -7.1 | -30.2 | -0.8 | -24.3 | 21.3 | 18.6 |
| Total net flows | -5.1 | 5.5 | 43.2 | 141.7 | -103.9 | -69.0 | 8.7 |
| Change in reserves ^e | 1.7 | -37.7 | -137.3 | -169.9 | 35.8 | 19.8 | -76.7 |

Source: IMF, World Economic Outlook Database, October 2009.

^a Partly estimated.

^b Forecasts.

^c Including portfolio debt and equity investment.

^d Including short- and long-term bank lending, and possibly some official flows owing to data limitations.

^e Negative values denote increases in reserves.

In order to achieve a more orderly and—in human terms—less costly reduction of international financial transfers from poor to rich countries, faster demand growth in developing countries would be required. However, most developing countries have limited monetary and fiscal space to maintain domestic demand. This space is being further constricted by the crisis. Additional resources for developing countries have been made available through decisions by leaders of the G20 through lending by the international financial institutions (IFIs), especially the International Monetary Fund (IMF). The disbursement of these resources so far has been restrained as, in many cases, they remain subject to restrictive policy conditionality, despite the recent reforms on conditionality by the IMF. The conditionality reforms have not yet addressed the issue of the counter-cyclical policy space required by developing countries in both periods of normalcy and in times of crisis.

As discussed in chapter I, the structural problems underlying the emergence of exploding global imbalances have not been removed, and present policy efforts for recovery could well cause a re-emergence of macroeconomic imbalances in the absence

Current policies could lead to a renewed increase in global imbalances

of a practical international counter-cyclical framework. The substantial surge in the government deficit of the United States of America will likely exert renewed impetus on its external deficit. In Asia in particular, conditions of high dependence on exports for growth (a dependence that will take significant time and investment to reduce) and relatively weak domestic demand have not fundamentally changed.

Exchange-rate instability
is a major risk

The potential return of global imbalances in the context of a recession and mounting public indebtedness in the major economies increases the risks of exchange-rate instability and strong downward pressure on the dollar. As the world economy shows its first signs of recovery, financial investors have rediscovered an appetite for risk in high-yielding currencies and emerging market equities. This has not only diminished the appeal of the United States dollar as a safe-haven currency but, owing to the anticipation of investors that current United States interest rates will be kept on hold for the foreseeable future, has caused the dollar to become the de facto carry-trade currency. The restored dominance of speculative motives for investment over fundamentals is reflected in the fact that, despite uncertainty about the sustainability of the current recovery in many emerging markets, financial investors are showing a widespread appetite for a huge variety of high-yielding asset classes. The sizeable amounts of speculative capital in emerging markets add new policy management challenges for Governments, as currencies have come under pressure to appreciate. Emerging economy authorities have been responding to the substantial increase in capital inflows by accumulating reserves or, as in the case of Brazil, by attempting to tax capital inflows in order to avoid currency appreciation. There also remains the possibility of a destabilizing reversal in portfolio flows should United States interest rates begin to increase, bursting asset bubbles in emerging markets and inducing a rapid drain on their foreign-exchange reserves.

Private capital flows

Private capital flows to developing countries

The total value of financial
assets has fallen sharply

The global financial crisis and worldwide recession imposed a sudden stop on nearly three decades of expansion in international capital markets. From 1980 through 2007, the world's financial assets—including equities, private and public debt, and bank deposits—nearly quadrupled in size relative to world gross product (WGP). Similarly, global capital flows surged. But the upheaval in financial markets in 2008 broke this trend. The total value of the world's financial assets in 2008 fell by \$16 trillion, to \$178 trillion, the largest setback on record.¹

All components of private
capital flows have
declined ...

In developing countries, which have been attracting high and growing levels of private capital flows since 2002, the trend reversed sharply in the second half of 2008. Across the board, all components of private capital flows registered significant declines. (table III.2) One of the most salient features of the financial turmoil was a steep and simultaneous fall-off in all cross-border capital flows, including FDI, foreign equities, debt securities and cross-border lending. The sharp correction in cross-border lending was the biggest contributor to the contraction in capital flows, exerting severe funding pressures on developing countries. Countries with large current-account deficits, and therefore the most dependent on foreign capital, were hardest hit by the substantial tightening of credit conditions in international

¹ McKinsey & Company, "Global capital markets: Entering a new era", McKinsey Global Institute report, September 2009.

markets. But even middle-income countries with current-account surplus positions were substantially affected by the global financial crisis, as a sell-off in assets triggered a marked depreciation of exchange rates in a large number of economies.

The reversal continued through the first quarter of 2009, with net capital flows to developing countries shifting further downwards on an annualized basis. However, as a result of stimulus packages and other policy measures to recapitalize financial institutions, signs of stabilization have become noticeable in various parts of the financial market. Positive macroeconomic news, as well as encouraging earnings announcements by private corporations, has gradually improved the sentiment of financial investors since the second quarter of 2009. Surprisingly, several large commercial banks in major economies not only reported strong earnings in the second quarter of 2009 but outperformed other types of financial institutions in both credit and equity markets.² Equity prices worldwide have rebounded strongly and, owing to government stabilization support of major financial institutions, interbank lending conditions have generally been improving. Improvements were also visible in credit markets, even though important segments continue to rely on central bank support.

In particular, prices of equities in emerging markets have increased along with those in developed countries. In emerging Asia, the current upswing in external financing is predominantly driven by equity-related flows. The spread on JPMorgan's Emerging-Market Bond Index (EMBI) reached 800 basis points at the height of the crisis in October 2008 but significantly declined to 300 basis points in October 2009. This spread, which reflects how much more yield investors demand to hold emerging market debt compared to safe-haven United States Treasuries, has declined to almost pre-crisis levels. Consequently, the cost and availability of debt financing in emerging countries has improved, and financial investors have rediscovered an appetite for risk in high-yielding currencies and emerging market equities. The IMF refers to this development in its latest *Global Financial Stability Report*,³ warning that the decline in sovereign debt spreads has been driven almost entirely by an improved global appetite for risk and core market liquidity, despite underlying economic fundamentals' continuing to deteriorate in many countries. This creates renewed exposure of emerging countries to sudden shifts in investor sentiment in the coming months.

As also suggested in previous issues of *WESP*, credit default swap (CDS) spreads are a better indicator of sovereign risk than the EMBI in periods of crisis. CDS spreads represent the marginal cost of debt, while the EMBI for a country is more representative of the average cost of traded debt. During distress, it is the marginal cost that is often more relevant; although CDS spreads are a derivative of the cash bond market, their volatility and absolute levels may lead to a sell-off in the underlying bonds. This distinction is important since EMBI spreads, being the weighted average of all bonds, reflect a market risk perception of longer duration. Sovereign CDS spreads are usually quoted for no longer than a five years; hence, they reflect a much shorter loan maturity than bonds.

... but signs of stabilization have occurred in various parts of the financial market

Equity markets have rebounded in emerging markets

Credit default swaps are a better indicator of sovereign risk

² Bank for International Settlements, "International banking and financial market developments", *BIS Quarterly Review*, September 2009.

³ See International Monetary Fund, *Global Financial Stability Report* (Washington D. C.: IMF, October 2009). The World Bank comes to a similar conclusion in its updated forecast for the Asia and Pacific Region, arguing that although a stronger rebound in equity prices in East Asia is to be expected given perceptions about growth and the region's much increased role in the global economy, the speed of the increase has led to renewed concerns about speculative bubbles (World Bank, *Transforming the Rebound into Recovery*, a World Bank economic update for the East Asia and Pacific region (Washington D. C.: World Bank, November 2009)).

Sovereign bankruptcy risks have decreased, but remain high in some countries

As can be seen in table III.3, at the end of October 2009, the bankruptcy risk of emerging market Governments decreased substantially compared with much higher default probabilities in the last quarter of 2008. In our sample, Ukraine still has the highest CDS premium (10.6 percentage points), followed by the Bolivarian Republic of Venezuela (9.7 percentage points). The higher premium in these countries can be explained by the specific challenges to their economies and is to a lesser extent due to global conditions. Ukraine, which has been confronted with a sharp contraction in economic activity, has very limited access to resources for meeting its mounting financing needs. It has lost access to international financial markets, and this situation is reinforced by additional political and economic uncertainties that seem to be feeding on each other. The Bolivarian Republic of Venezuela is expected to continue to register high inflation rates of about 30 per cent (see chapter IV), driven by higher taxes and a shortage of essential products, and this is reflected in higher CDS spreads.

Liquidity conditions have improved

Capital inflows to developing countries have rebounded, leading to improved liquidity conditions. The Institute of International Finance (IIF) predicts that the current upswing in emerging economies will mainly be based on equity-related flows and will thus lead to an important rotation in the debt-equity mix in external financing for at least the next few years.⁴ Portfolio equity flows, which are at the cutting edge of this debt-equity rotation, have shown a dramatic turnaround in 2009. For a group of 30 emerging markets, the IIF projects that net inflows of portfolio equity in 2009 should reach \$82 billion, compared with net outflows of the same amount in 2008. However, given the fact that some of the returning portfolio flows may well be speculative, bouts of volatility and a potential partial reversal of portfolio flows could make countries vulnerable to setbacks in economic performance.

Bank lending has registered the sharpest decline among flows of private capital

Bank lending to emerging economies showed the sharpest decline among all components of private capital flows in 2008 and banks continued to trim their exposures in 2009, whereas a slow rebound can be expected in 2010 at the earliest. Interestingly,

Table III.3
Credit default swap spreads and annual probabilities of default in selected emerging market countries

| | <i>CDS spreads</i> (basis points) | | <i>Annual probabilities of default^a</i> (percentage) | |
|---------------------------------------|--------------------------------------|------------------------|--|------------------------|
| | <i>23 October 2008</i> | <i>23 October 2009</i> | <i>23 October 2008</i> | <i>23 October 2009</i> |
| Brazil | 571 | 130 | 6.3 | 1.7 |
| Hungary | 574 | 201 | 6.4 | 2.5 |
| Korea, Republic of | 620 | 92 | 6.8 | 1.2 |
| Mexico | 580 | 160 | 6.4 | 2.0 |
| Russian Federation | 1 056 | 180 | 10.1 | 2.3 |
| Turkey | 777 | 182 | 8.1 | 2.3 |
| Ukraine | 2 535 | 1 129 | 16.3 | 10.6 |
| Venezuela (Bolivarian Republic of) | 2 224 | 990 | 15.5 | 9.7 |

Source: UN/DESA, based on data of Deutsche Bank Research, available at <http://www.dbresearch.com>.

^a Calculated at a recovery rate assumption of 25 per cent.

⁴ Institute of International Finance, *Capital Flows to Emerging Economies* (Washington, D.C.: October 2009).

most of the registered reductions in the outstanding stock affected international claims, while positions in local currencies remained relatively stable during this period. Non-bank lending flows also declined markedly during the crisis, but have rebounded notably since mid-2009, as net external bond issuance by emerging markets has increased in recent months. This trend is expected to increase in 2010.

Amid the current improvements in financial sectors, any forecast of net private flows in 2010 is subject to downside risks and uncertainties in the world economy. The stronger-than-expected rebound in equity prices worldwide belies the fact that credit channels are still impaired and the economic recovery is likely to be slow. Investor sentiment largely driven by an improved global appetite for risk for high-yielding assets rather than based on underlying economic fundamentals can redirect herding behaviour against renewed optimism, creating new bouts of volatility. The emergence of large capital inflows also carries with it the risk of new asset price bubbles, thereby complicating macroeconomic policy responses. While stronger bank earnings are currently supporting capital levels, additional writedowns of impaired assets will be necessary in the coming months and this will affect lending capabilities. Since the real sector is lagging behind the rebound in the financial sector, and is expected to remain subdued in 2010, excess capacity remains high. Therefore, Governments need to be mindful of the risks of a premature withdrawal of stimulus, given the large output gaps as well as concerns that developed countries are converging towards a slower growth path than prior to the crisis. Downside risks include a double dip in economic activity, in particular in the advanced countries, as effects of stimulus measures and inventory restocking wear off.

From a regional perspective, the impact of the global financial turmoil on Africa has been limited, as risks in the majority of financial markets in the region were uncorrelated with those in mature economies. FDI inflows to Africa reached another record level despite the global financial crisis in 2008, but are likely to decline in 2009.⁵ The recovery of commodity prices in the second quarter of 2009 has helped stimulate economic growth in the region, albeit at a much lower pace than prior to the crisis. Economic growth in sub-Saharan Africa is estimated to expand by just 1 per cent in 2009, compared to 6.5 per cent between 2002 and 2007. Recovery in South Africa is expected only in 2010, since that country experienced not only negative growth rates that continued into most of 2009, but also severe capital outflows. This pattern reversed itself in the latter part of 2009 since South Africa was able to finance its large current-account deficit with increasing net inflows that were boosted by improved credit market conditions and strong portfolio equity flows.

East and South Asia are experiencing the most significant rebound in private capital flows in 2009. The dramatic reversal in portfolio equity flows reflects the net buying of equities by foreign investors. As growth prospects have improved in the region, portfolio inflows have more than compensated for the decline in bank lending that still remain subdued in 2009. Policymakers in Asia have been successful in using international reserves and swap facilities to increase credit flows, support domestic liquidity and stimulate demand. The boost in portfolio flows has been particularly pronounced in the Republic of Korea and India, which together have accounted for almost the entire turnaround in emerging Asia in 2009.⁶ Continued large capital inflows, combined with strong

Significant risks remain with regard to future net private capital flows

The impact on Africa has been limited

East and South Asia have benefited from strong portfolio inflows

⁵ United Nations Conference on Trade and Development, *World Investment Report 2009: Transnational Corporations, Agricultural Production and Development* (United Nations publication, Sales No. E.09.II.D.15).

⁶ Institute of International Finance, "Capital flows to emerging market economies", *IIF Research Note*, 3 October 2009.

domestic credit growth and higher commodity prices could not only enlarge asset bubbles but also create inflationary pressures in some countries. As a result, monetary authorities might consider it essential to tighten monetary policies much earlier than originally anticipated, thereby creating adverse impacts on the real sector of the economy and the path to recovery.

Western Asia has seen a sharp reversal in credit flows

The massive increase in credit flows to Western Asia during 2007 was followed by a sharp reversal in 2008 and inflows remained weak in 2009. Along with the global credit crunch, Saudi Arabia and the United Arab Emirates in particular have experienced net outflows in 2009 in the form of net repayments to banks. However, as both the Governments and the central banks in oil-exporting countries were in strong financial positions, tighter credit conditions had only a limited effect on real investment activities in the region. Governments actively stimulated domestic credit expansion and private investment. With the recovery of oil prices in the second quarter of 2009, asset growth has picked up again in oil-exporting countries and has stimulated the accumulation of international reserves.

Latin America and the Caribbean have also seen an upswing based on equity-related flows

Economic growth prospects have improved in Latin America and the Caribbean, since a sharper deceleration of external demand during the height of the crisis had been prevented in several countries with active counter-cyclical policies. While net private inflows in 2009 have been lower in the aggregate than in 2008, Brazil has already taken the lead in the region by attracting increased capital inflows. Similar to the development in Asia, the upswing is mainly dominated by equity-related flows, showing a sharp rebound in portfolio investment. Bank credit growth in Latin America and the Caribbean has stabilized in recent months, suggesting that policy actions have been successful in halting the deterioration in financial conditions. However, since banks remain cautious amid uncertainty about the recovery, credit growth remains sluggish. Oil-exporting countries in the region, such as Ecuador, Mexico and Venezuela (Bolivarian Republic of), have so far only benefited to a lesser extent by the rise in commodity prices. The space for additional counter-cyclical measures in these countries might be significantly reduced in 2010 owing to budgetary constraints and high debt levels.

Oil prices and equity markets have been driving the performance of the economies in transition

The rise in oil prices and improvements in equity markets, despite a continuing pullback in net bank lending and deteriorating trade balances, have been critical to the recent performance of the economies in transition. Most significantly, the current-account surplus of the Russian Federation will turn to a deficit in 2009. Given that budget deficits have been allowed to increase rapidly to finance generous stimulus measures, the Russian Federation could face further financing challenges in 2010.

Trends in foreign direct investment

FDI inflows will recover slowly in 2010

At the global level, FDI inflows are expected to fall from \$1.7 trillion in 2008 to below \$1 trillion in 2009, and show a slow recovery in 2010 (see table III.4).

The global economic slowdown has had a variety of impacts on FDI inflows. The decline was more distinct in developed countries, while several developing markets were still continuing to experience increasing FDI inflows in 2008 despite the financial turmoil. Thus, the crisis has changed the FDI landscape:⁷ investments to developing and transition economies surged, increasing their share in global FDI flows to 43 per cent in 2008. In Africa, inflows rose to a record level, the fastest increase being in West Africa.

Table III.4
Inflows of foreign direct investment and cross-border mergers and acquisitions,
by region and major economy, 2008-2009

| Billions of dollars | | | | | | | |
|---------------------------------|-----------------------------------|-------------------|--------------------------|---|--------------|-----------------|--------------------------|
| | Foreign direct investment inflows | | | Cross-border mergers and acquisitions, net sales ^b | | | |
| | 2008 | 2009 ^a | Growth rate (percentage) | 2008 | | 2009 | Growth rate (percentage) |
| | | | | First 10 months | Full year | First 10 months | First 10 months only |
| World | 1 697.4 | 1 039.0 | -38.8 | 571.4 | 673.2 | 204.4 | -64.2 |
| Developed economies | 962.3 | 543.7 | -43.5 | 452.8 | 551.8 | 172.3 | -62.0 |
| Europe | 518.3 | 403.8 | -22.1 | 232.9 | 245.7 | 114.4 | -50.9 |
| United States | 316.1 | 98.7 | -68.8 | 150.4 | 225.8 | 42.9 | -71.5 |
| Japan | 24.4 | 13.6 | -44.5 | 8.3 | 9.2 | -6.4 | -177.8 |
| Developing economies | 620.7 | 428.6 | -31.0 | 98.1 | 100.9 | 30.2 | -69.2 |
| Africa | 87.6 | 74.7 | -14.7 | 20.8 | 20.9 | 6.0 | -71.1 |
| Latin America and the Caribbean | 144.4 | 87.4 | -39.5 | 12.4 | 15.2 | -4.8 | -138.5 |
| Asia and Oceania | 388.7 | 266.5 | -31.4 | 64.9 | 64.7 | 29.0 | -55.3 |
| Western Asia | 90.3 | 53.5 | -40.7 | 14.1 | 14.7 | 1.8 | -87.4 |
| South, East and South-East Asia | 297.6 | 204.1 | -31.4 | 50.7 | 50.8 | 27.2 | -46.4 |
| Economies in transition | 114.4 | 66.7 | -41.7 | 20.5 | 20.5 | 1.9 | -90.7 |

Source: UNCTAD.

Note: World FDI inflows are projected on the basis of 134 economies for which data are available as of 19 November 2009. Data are estimated by annualizing available data, in most cases for the first two quarters of 2009. The proportion of inflows to these economies in relation to total inflows to their respective region or subregion in 2008 is used to extrapolate the 2009 data.

a Preliminary estimates.

b Net cross-border M&A sales in a host economy are sales of companies in the host economies to foreign TNCs (excluding sales of foreign affiliates in the host economy). The data covers only those deals that involved an acquisition of an equity stake of more than 10 per cent.

This constituted a 27 per cent rise over 2007, and a large portion of these flows were mainly attracted by producers of natural resources. In Latin America and the Caribbean, FDI inflows increased by 13 per cent, continuing the upward trend of the preceding years. Inflows to South, East and South-East Asia witnessed a 17 per cent expansion, while FDI to Western Asia continued to grow for the sixth consecutive year in 2008. FDI inflows to South-eastern Europe and the CIS rose for the eighth year running. However, in 2009 FDI flows to all regions will suffer from a decline.

FDI has been the most stable component of cross-border private capital flows during the past few years, buoyed by strong economic growth and improvements in the investment climate in a number of countries. In the first half of 2008, developing countries weathered the incipient global financial crisis better than developed countries, as their economic growth remained robust, supported by rising commodity prices. However, in the second part of the year and into 2009, as a result of the deep contraction in world economic activity, FDI inflows were severely affected. Given that an increasing proportion of these flows came in the form of reinvested earnings, the level of investment collapsed in the downturn of the business cycle. According to the United Nations Conference on Trade and Development (UNCTAD), lower profits by foreign affiliates drove down reinvested earnings, contributing to the 46 per cent drop in FDI outflows from the developed countries in the first quarter of 2009.

FDI was severely affected by the crisis

FDI was also dragged down by weaker merger and acquisitions activity

The increase in FDI flows in 2008 was fuelled by cross-border mergers and acquisitions (M&As), which declined with the worsening of the financial turmoil in developed country financial markets in the second half of 2008. With the sharp deterioration in banking-related flows, it became more difficult for investors to finance M&A activities. UNCTAD reports that in the aggregate for 2008 only the primary sector witnessed growth of 17 per cent in the value of M&A sales, whereas manufacturing and services—which account for the largest proportion of world inward FDI stocks—reported declines of 10 per cent and 54 per cent, respectively. In conclusion, despite the decline in commodity prices, long-term trends in M&As continued to hold in times of crisis. While the services sector still accounts for the largest share of global FDI flows, there has been a significant increase in FDI flows to the primary sector, mainly to extractive industries. The share of manufacturing in global FDI flows has continued to decline. The share of transnational corporation (TNC) investments in extractive industries has more than doubled since the 1990s. These industries account for a significant share of total FDI inflows in some economies and for the bulk of inward FDI in a number of low-income mineral rich countries.

The impact on FDI by special funds varied

The economic and financial crisis had varying impacts on FDI undertaken by special funds, such as sovereign wealth funds (SWFs) or private equity funds. Private equity firms, which account for one fifth of global cross-border M&As, are highly dependent on bank loans and therefore became severely limited in their financing options in 2008. Consequently, cross-border M&As by these firms fell by 38 per cent in 2008. SWFs, on the other hand, recorded a rise in FDI in 2008, even despite a fall in commodity prices, whose export earnings often provide these funds with financing. The value of SWF-related cross-border M&As increased in 2008 by 18 per cent.

The crisis in business cycle-sensitive industries reduced FDI

Many business cycle-sensitive industries, such as automotives and transport materials, metal and non-metal products, chemicals, and, more generally, the manufacturing sector as a whole, have been among the worst affected by the crisis, and thus had a direct negative impact on future FDI plans of TNCs. On the other hand, some less cyclically-sensitive activities that rely on less income-elastic elements of domestic demand (such as agro-food and many services) or on supplying markets with quick growth prospects in the medium term (such as pharmaceuticals) have been less affected. Furthermore, in terms of preferred regions for FDI, East, South and South-East Asia remains the most favoured destination. The majority of respondents to a recent UNCTAD survey consider the growth of markets in this region—and, to a very limited extent, the availability of affordable labour costs—the main criterion for their investment decisions.

FDI is expected to remain weak in 2009

Global FDI is set to remain weak for 2009, as corporations might remain hesitant and bearish about expanding their international operations. UNCTAD estimates⁸ that after a slow recovery in 2010, inflows are expected to reach \$1.8 trillion in 2011, that is to say, almost the same level as in 2008.

International financial cooperation

Official development assistance

The crisis puts further pressure on aid budgets

Measured against international commitments, aid delivery had been falling short even before the onset of the global economic crisis. The crisis will now put further pressure on aid budgets of donors and on the economic and social conditions of many developing countries. This

⁸ Ibid.

new problem is well understood by the international community and several pronouncements have been made to mitigate the impact. In April 2009, G20 leaders reaffirmed their commitment to achieve their official development assistance (ODA) pledges and agreed to provide additional financial support to low-income countries. Subsequently, the Development Committee of the IMF and World Bank urged all donors not only to accelerate the delivery of their aid commitments but also to consider going beyond existing ones. At the special high-level meeting of the Economic and Social Council with the Bretton Woods institutions in April 2009 and the High Level Meeting of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) in May 2009, donors reiterated their determination to fulfil their ODA commitments, despite their domestic financial difficulties. Members of the DAC reaffirmed their existing ODA commitments, especially those for Africa.

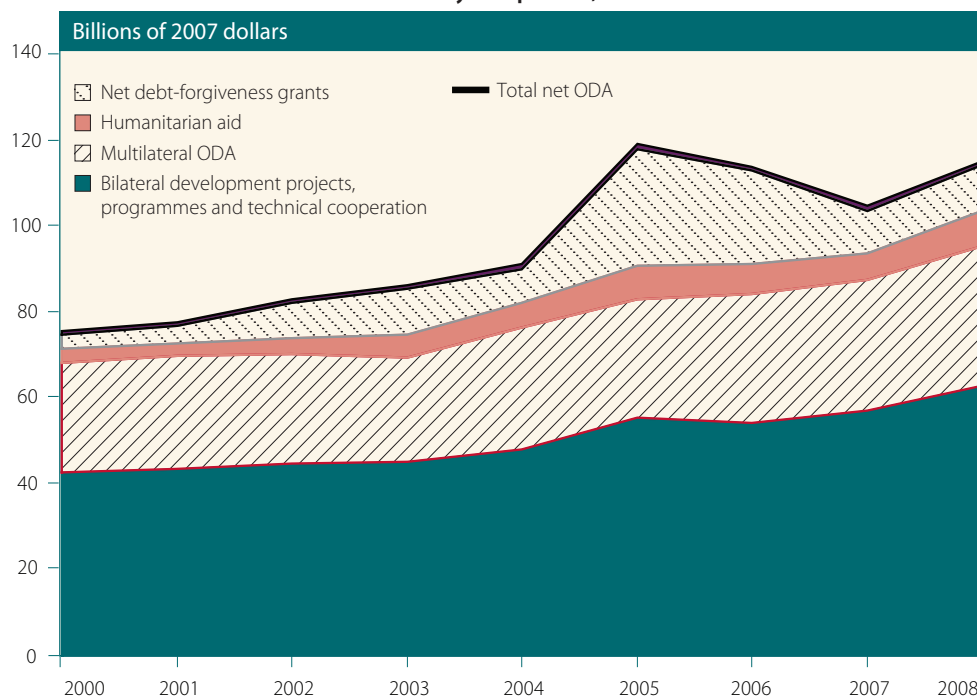
In 2008, total net ODA from the DAC member countries rose by 10.2 per cent in real terms and, excluding debt relief, reached its highest ever recorded level of \$119.8 billion (figure III.1).⁹ Donors increased their bilateral development projects by 12.5 per cent.¹⁰ Among the DAC member countries, the largest donors in 2008 were the United States (\$26.0 billion), Germany (\$13.9 billion), the United Kingdom of Great Britain and Northern Ireland (\$11.4 billion), France (\$11.0 billion) and Japan (\$9.4 billion).

Net ODA reached 0.30 per cent of the DAC member countries' combined gross national income (GNI) in 2008, a marginal increase from the 2007 level of 0.28

Total net ODA from the DAC members peaked in 2008

ODA by DAC member countries remains below its target level

Figure III.1
Total ODA flows from DAC countries by component, 2000–2008



Source: UN/DESA, based on data of the OECD/DAC database, available at http://www.oecd.org/document/33/0,2340,en_2649_34447_36661793_1_1_1_1,00.html#dac.

⁹ Organization for Economic Cooperation and Development, "Development aid at its highest level ever in 2008", *OECD News*, 30 March 2009, available at <https://www.oecd.org>, table 1.

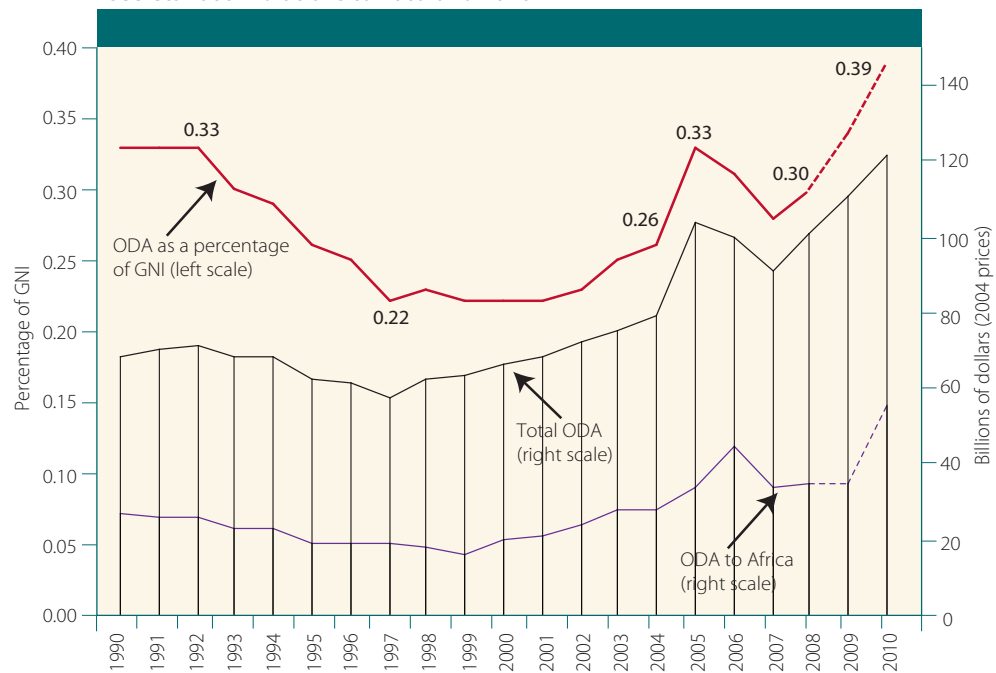
¹⁰ United Nations, *The Millennium Development Goals Report 2009* (United Nations publication, Sales No. E.09.I.12), p. 48.

per cent (figure III.2). This figure, however, remains significantly below the 0.7 per cent target reaffirmed in the Monterrey Consensus adopted at the United Nations International Conference on Financing for Development in March 2002, although Denmark, Luxembourg, the Netherlands, Norway and Sweden have been exceeding the target for many years now.

Non-DAC actors are becoming more relevant

Among the non-DAC countries, whose contributions are now estimated to reach 8-10 per cent of global aid flows, the 31.5 per cent increase in net ODA in 2008 from the Republic of Korea was the most notable, exceeding the ODA levels of Greece, New Zealand and Portugal.¹¹ The Republic of Korea increased its contributions to regional development banks and funds in 2008 and expects to become a DAC member in 2010. China, India, Saudi Arabia and Venezuela (Bolivarian Republic of) are emerging as major donors from the South. Brazil and Thailand are also increasing their contributions.¹² The importance of development assistance from non-governmental organizations (NGOs) and the private sector is gaining recognition. It is estimated that private giving towards development amounted to close to \$20 billion in 2007, even given the substantial possibility of underreporting.¹³ The presence of non-DAC actors creates competitive pressures and increases choice among the types of aid and donors. Traditional donors

Figure III.2
Net ODA of DAC members, 1990–2008, and DAC secretariat simulations to 2009 and 2010



Source: OECD/DAC database, available at <http://www.oecd.org/dataoecd/47/57/42458739.pdf>.

Note: Dollar values are in 2004 prices.

- 11 Organization for Economic Cooperation and Development, "Development aid at its highest level ever in 2008", op. cit.
- 12 Lama Hammad and Bill Morton, "Non-DAC donors and reform of the international aid architecture", *Issues Brief*, July 2009 (Development Cooperation Series, The North-South Institute).
- 13 Mathew Martin and Jonathan Steve, "Key challenges facing global development cooperation", discussion paper prepared for the 2007 United Nations Development Cooperation Forum, Geneva, 5 July 2009, p. 21.

have expressed concern that the entry of other donors could undermine progress on aid effectiveness.¹⁴

A March 2009 OECD/DAC survey of future spending plans indicates that total net ODA from DAC members in 2010 would be about \$121 billion (in 2004 prices), which still falls short of the target \$130 billion.¹⁵ In 2008 prices and exchange rates, OECD/DAC estimates the total delivery gap towards the 2010 target to be \$35 billion, of which \$10 billion would be the required increase on top of the planned ODA budgets by 2010.

Africa was the largest ODA recipient, receiving \$42 billion, or 35 per cent of global ODA in 2008. Excluding debt relief, bilateral ODA to Africa rose by 11 per cent. ODA to sub-Saharan Africa more than doubled from 2000 to 2007. Despite this progress, however, aid to Africa needs to increase more rapidly since increases in the overall levels are accounted for mainly by relief contributions provided to Nigeria. At 2004 prices, the gap between delivery and the 2010 target is \$17 billion (\$21 billion at 2008 prices). The shortfall in ODA flows to Africa accounts for 60 per cent of the shortfall between the delivery in 2008 and the 2010 global commitments.¹⁶

Since the adoption of the Brussels Programme of Action for the Least Developed Countries for the Decade 2001-2010 in May 2001, ODA flows to least developed countries (LDCs) have increased from less than \$14 billion in 2001 to a record level of \$32 billion in 2007.¹⁷ Aid flows to 49 LDCs account for one third of global ODA. While the share of ODA in GNI from the DAC countries to the LDCs is increasing (0.05 per cent in 2001 to 0.09 per cent in 2007), it remains short of the target rate of 0.15-0.20 per cent. All donor countries, except Portugal, increased or maintained the proportion of their GNI allocated as ODA to the LDCs between 2000 and 2007. The number of DAC countries that met the target of 0.15 per cent increased from five to eight during the same period. Greece and the United States, however, allocated less than 0.05 per cent of their GNI as ODA to the LDCs in 2007.¹⁸ LDCs receive much higher ODA per capita than other developing countries, but the distribution among them is quite uneven. About one sixth of LDCs (or eight countries, accounting for 16 per cent of the group's population) received more than half of the total ODA allocated to this group in 2006-2007. In the case of multilateral ODA, the channelling of resources towards poor countries improved between 2000 and 2006, but considerable scope remains for achieving a more equitable distribution of bilateral ODA between higher- and lower-income developing countries.

Absolute levels of ODA flows in 2009 are likely to fall in response to the global economic contraction. The impact of negative shocks in the current year may also

There is a shortfall in ODA from DAC members

Increased aid to Africa is mainly the result of relief contributions to Nigeria

LDCs receive relatively high but unevenly distributed ODA per capita

Aid budgets are expected to decrease

¹⁴ From the viewpoint of traditional donors, non-DAC donor aid programmes fall short of long-term social development dimensions, applying less conditionality and higher levels of tied aid. Also, non-DAC aid is often directed to Governments with poor track records in human rights as a means to pursue the donor Government's short-term foreign policy objectives. Some traditional donors are also apprehensive that the availability of easily accessible loans by donors from the South may lead to a new debt crisis and reverse the progress in ongoing debt relief efforts (see Hammad and Morton, 2009).

¹⁵ Organization for Economic Cooperation and Development, "Development aid at its highest level ever in 2008", op. cit.

¹⁶ United Nations, *MDG Gap Task Force Report 2009: Strengthening the Global Partnership for Development in a Time of Crisis* (United Nations publication, Sales No. E.09.I.8), p. 8.

¹⁷ Loc. cit.

¹⁸ Loc. cit.

lead to a long-term contraction in aid budgets.¹⁹ Cutting aid from major donors at this point in time would not only create additional fiscal burdens on developing countries but could also reverse some of the progress already made towards meeting the Millennium Development Goals (MDGs). How aid can play a counter-cyclical role to help respond to the sharp reversal in overall financial flows to developing countries presents an important policy challenge.

Greater aid effectiveness requires stronger commitments and better coordination

Aid effectiveness continues to be the main focus of DAC donor countries, as principal proponents of the Paris Declaration and the Accra Agenda for Action. Ensuring that aid can play a positive role in a time of economic downturn requires a stronger commitment from Governments and better coordination at global and national levels. Demonstrating improved effectiveness can facilitate domestic political support in trying economic times. The OECD DAC Working Party on Aid Effectiveness has begun selectively measuring performance at the country level. While it may be tautological to state that improved effectiveness ensures that each aid dollar has greater impact, the act of realizing this goal demands significant political and bureaucratic effort on the part of recipient countries. Countries that already have more effective political systems and bureaucracies can be expected to perform better when it comes to aid effectiveness, as they do in other aspects of development policy. In the context of the asymmetries inherent in donor-recipient interactions, mobilizing and monitoring the political and bureaucratic contributions to this effort on the part of the DAC donors themselves should logically be deemed a priority.

The Paris Declaration has become a national priority in several countries

In some recipient countries, such as Burkina Faso, Ghana, Mozambique and Viet Nam, the Paris Declaration has been made a national priority and its principles have been actively implemented.²⁰ In Ghana, Uganda, the United Republic of Tanzania and Zambia, joint assistance strategies have been developed to move from projects to programme-based and sector-wide approaches. Yet, the pace and depth of these efforts are not consistent across donor programmes and there is no one-size-fits-all strategy.

Expectations are high regarding the work of the UNDCF

In 2009 and 2010, the United Nations Development Cooperation Forum (UNDCF)²¹ is expected to focus on a series of interrelated and mutually reinforcing activities to promote national development and the achievement of MDGs in: (a) mutual accountability and aid transparency; (b) South-South and triangular cooperation; and (c) aid policy coherence, with a view to moving from aid to more long-term sources of development financing. A special focus will be given to issues of quality and impact of aid in the area of gender equality and the empowerment of women. High expectations are placed on the DCF, especially from non-DAC donors, and the outcomes of phase II of its activities will determine its future role in this area.

Innovative sources of development financing

ODA instruments have become more diversified

Since the Monterrey Conference on Financing for Development in 2002, international development assistance has seen noticeable diversification in the set of instruments for achieving specific development objectives. Innovative financing mechanisms have shown

¹⁹ Emmanuel Frot, "Aid and the financial crisis: shall we expect development aid to fall?" 13 May 2009, available at www.voxeu.org.

²⁰ Organization for Economic Cooperation and Development, *Managing Aid: Practices of DAC Member Countries* (Paris: OECD Better Aid series, 2009), p. 77.

²¹ Established in 2008 as the focal point within the United Nations system and as a principal forum for global dialogue and policy review on the effectiveness and coherence of international development cooperation.

some, while as yet limited, potential for complementing traditional development aid to achieve the MDGs by raising about \$2.5 billion since 2006.²² The innovative financing for development framework has a strong element of public-private partnership, joint design and decision-making among developing and developed countries in terms of raising the resources, while the traditional approach emphasizes the partnership only in relation to the use of resources. A new modality containing efforts and initiatives for collecting revenues for sector-specific international development cooperation through innovative channels has drawn continued attention from the international community, as there is an expectation that such funds can play a greater role in terms of raising revenues and addressing particular issues more effectively than traditional ODA.

Three groups—the High-Level Taskforce on Innovative International Financing for Health Systems, the Leading Group on Innovative Financing for Development and the I-8 Group/L.I.F.E. (Leading Innovative Financing for Equity)—have been influential in the work on innovative financing for development:

- The High-Level Taskforce on Innovative International Financing for Health Systems, whose first meeting was held in Doha in November 2008, explores and recommends actions for strengthening international assistance by advocating the protection of social sector investments regardless of the economic situation. The members of the Taskforce include the British Prime Minister, high government officials from European countries as well as from Ethiopia and Liberia, the President of the World Bank and the Director-General of the World Health Organization (WHO).
- The Leading Group on Innovative Financing for Development, working closely with the United Nations, serves as a platform for different initiatives and new ideas. The Group has brought together countries, international organizations and NGOs to strengthen international solidarity and facilitate international cooperation in this area by making possible the preparation of new initiatives and coordinating the channelling of funds.
- The newly formed I-8 Group/L.I.F.E consolidates eight existing and very promising innovative financing initiatives, including UNITAID,²³ the

²² See the report of the Secretary-General entitled, "Progress report on innovative sources of development finance", United Nations General Assembly, 29 July 2009 (document A/64/189).

²³ A Geneva-based organization founded in September 2006—under a hosting agreement with the World Health Organization (WHO)—to buy medications in high volume and negotiate lower prices of drugs, tests and treatments for HIV/AIDS, tuberculosis and malaria by using funds collected from airline ticket levies in participating countries. This organization is governed by a board composed of donors and recipient Governments (including Brazil, Chile, France, Norway and the United Kingdom of Great Britain and Northern Ireland) and representatives of African and Asian countries, some non-governmental organizations (NGOs) and the Bill and Melinda Gates Foundation. By financing UNITAID, donors can support its activities to negotiate 25-50 per cent rebates on the price of drugs and dispatch them across the world to countries that need them most. UNITAID also plays an important role in influencing manufacturers to invest in the research and development of drugs that otherwise would not be produced. Since 2006, UNITAID has raised and committed more than \$730 million to support 16 projects in 93 countries. Furthermore, UNITAID is expected to become a principal recipient of funds raised by the Millennium Foundation, whose start-up capital was provided by UNITAID in November 2008. The Millennium Foundation was established to achieve three health-related Millennium Development Goals (MDGs) by developing and implementing innovative financing mechanisms, and is governed by a board of representatives of donors and recipient Governments (including Brazil, Chile, France, Norway and the United Kingdom), NGOs and the Bill and Melinda Gates Foundation.

International Finance Facility for Immunisation (IFFIm)²⁴ and Debt2Health,²⁵ works closely linked with the United Nations system. Its mission is to reinforce the initiatives put forward by the High-Level Taskforce and the Leading Group and prepare the ground for new initiatives.

Expanding the number of players involved in this framework is currently an important priority for these groups, as is identifying a variety of realistic proposals for voluntary contributions and implementing them.

The innovative sources of financing for development today include voluntary contributions, taxes, equity investments, bonds, loans and guarantees. Tailoring these instruments to the specific needs and vulnerabilities of developing countries remains the major challenge. Visible progress has been made—especially in improving acute health problems in developing countries—through initiatives using the air-ticket solidarity levy, the advance market commitment (AMC) and the international financial facility (IFF). Many proposals are also emerging on climate change and illicit financial transfers.²⁶

With reference to the persistent gap between the pledges made by developed country leaders and actual delivery of ODA, the Special Envoy of the United Nations Secretary-General on Innovative Financing has highlighted the enormous potential as a new source of financing for development of levies on foreign-exchange transactions (which are currently untaxed and whose volume has been facilitated by globalization).²⁷ A globally coordinated levy of 0.005 per cent on transactions of the most widely traded currencies (the United States dollar, the euro, the pound sterling and the Japanese yen) would raise at least \$33 billion every year without curbing the demand for such currencies. One possibility is that proceeds of this levy can be managed and disbursed effectively by one of the I-8 Group/L.I.F.E. members that have demonstrated high standards of performance records.

To tackle the challenges of the recent global economic crisis and to mitigate its negative impacts on development, the Group of Eight (G8) Development Ministers' meeting in Rome on 11 and 12 June 2009 recognized innovative financing as a critical element in raising the necessary development resources alongside traditional ODA, and

Tailoring ODA instruments to specific needs remains important

Levies on foreign-exchange transactions offer significant revenue potential

The role of innovative financing is also recognized by the G8

²⁴ A British charity foundation created in January 2006 with the financial support of Italy, France, Norway, Spain, Sweden and the United Kingdom (and the World Bank serving as its treasury manager) to fund immunization programmes and strengthen health systems in developing countries. South Africa joined as a donor in 2007, and Brazil is considering joining. Under this initiative, funds are raised by issuing bonds with donors' pledges. The first issuance of a vaccine bond in November 2006 raised \$1 billion. So far, \$2 billion has been raised. By issuing an additional \$4 billion worth of bonds, IFFIm projects an increase in its spending by \$500 annually until 2015 to finance vaccination programmes via the Global Alliance for Vaccines and Immunisation (GAVI) Fund, which manages and allocates resources to immunization projects. The scheme also intends to assist developing country Governments in budgeting and planning for their own immunization programmes.

²⁵ Debt2Health, launched in September 2007, is an innovative financing initiative of the Global Fund to Fight Aids, Tuberculosis and Malaria. Under this initiative, a donor government cancels a certain amount of debt owed by a developing country with high debt and high disease burden. To date, two agreements have been signed: between Germany and Indonesia (September 2007), by which Germany cancelled €50 million and Indonesia would invest the equivalent of €25 million in health through approved Global Fund programmes; and between Germany and Pakistan (December 2008), by which Germany cancelled €40 million and Pakistan would invest €20 million in Global Fund-approved domestic programmes. In May 2009, Australia joined the initiative and offered an \$A 75 million Debt2Health swap to Indonesia to fight tuberculosis. Further information is available at http://www.theglobalfund.org/documents/innovativefinancing/Factsheet_d2h_en.pdf.

²⁶ Report of the Secretary-General, United Nations General Assembly, op. cit.

²⁷ Philippe Douste-Blazy, "A tiny tax could do a world of good", *The New York Times*, 24 September 2009.

proposed acceleration of scale and speed in the implementation of innovative financing mechanisms.²⁸ The G8 ministers further noted that the functioning of such mechanisms should be consistent with the principles of the Paris Declaration and the Accra Agenda for Action and should maximize their effectiveness, and endorsed the work undertaken by the three influential groups mentioned above.

A genuine need exists to scale up innovative financing as a complementary, more stable and predictable source of development finance. Building on the experiences of existing mechanisms, the international community can pursue a variety of feasible innovative mechanisms and maximize their impact on development. Closer collaboration with international and regional organizations in monitoring existing mechanisms may be imperative in this respect.

Innovative financing needs to be scaled up

Debt relief

Since the adoption of the Monterrey Consensus in 2002, the international community has made notable progress in reducing the external debt burden of developing countries.²⁹ The ratio of debt-service payments of the 35 post-decision-point heavily indebted poor countries (HIPC) (those qualified for debt relief) declined from 3.2 per cent of gross domestic product (GDP) in 2001 to 1.1 per cent of GDP in 2008.³⁰ As a result, these 35 countries have increased their spending on health, rural infrastructure and education (or “poverty-reducing expenditure”) on average from 6.3 per cent of their GDP to 8.2 per cent of GDP in 2008.³¹ Nevertheless, owing to the global financial crisis, a large number of developing countries are facing renewed fiscal stress and challenges. In addition to lower revenues and currency depreciation, external financing conditions from public and private sectors tightened. All these factors pose serious risks to the debt sustainability of developing countries and their capacity to service or roll over external debt.

Despite notable progress on debt relief, risks remain

The ratio of external debt to export revenues fell further to 4.1 per cent in 2008 (compared to 12.7 per cent in 2001) for the 35 post-decision-point HIPC (figure III.3). However, the global economic slowdown has affected the external debt situation of developing countries through a variety of channels. Many developing countries, including those that benefited from the current debt-relief initiatives, face enormous pressures on external payments and fiscal budgets. The situation has been particularly severe for the commodity-exporting countries. The fall in foreign-exchange earnings is expected to exacerbate the burden of existing debt-servicing obligations. Moreover, the reduction in export revenues, followed by higher costs for imported food and fuel have also contributed to overall balance-of-payments difficulties in many developing countries.

Various factors are at play in affecting the external debt situation of developing countries

The weakened external payments’ position has been accompanied by the deterioration in fiscal positions. Currency depreciations have increased the domestic cost of servicing external debt, and the fall in exports has reduced not only hard currency earnings but also tax revenues from export-related activities and import duties. While countries with large foreign reserves or fiscal stabilization funds may be able to cushion

Fiscal positions have deteriorated

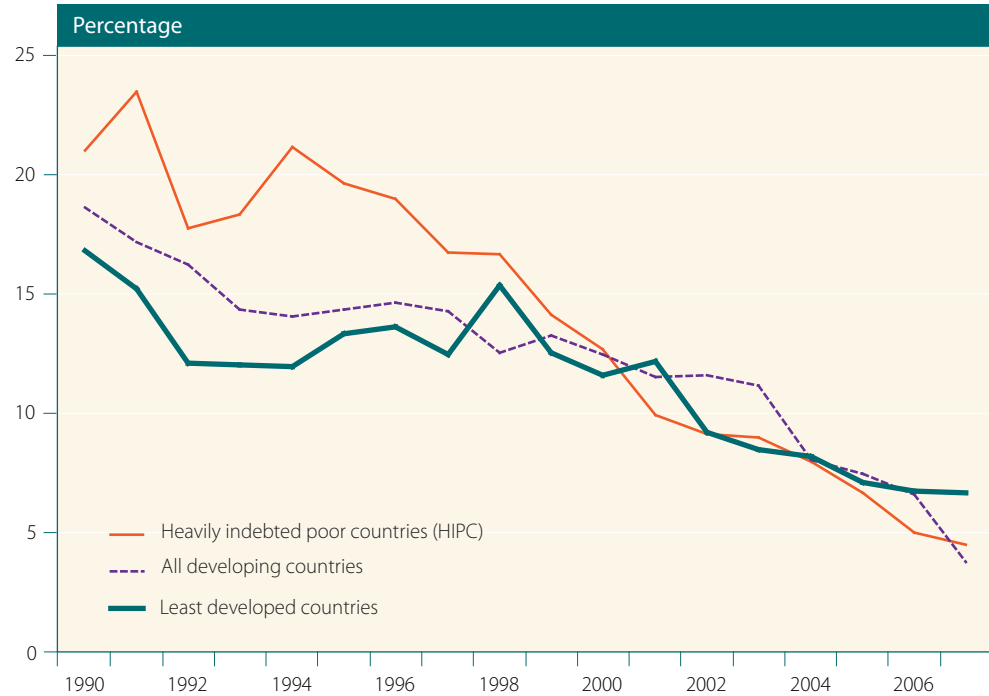
²⁸ See “Chair’s Summary: G8 Development Ministers’ Meeting”, Rome, Italy, 12 June 2009, available at http://www.canadainternational.gc.ca/g8/ministerials-ministerielles/2009-06-11_Rome-DevtMin.aspx.

²⁹ United Nations, *MDG Gap Task Force Report 2009*, op. cit.

³⁰ International Development Association and International Monetary Fund, “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of implementation”, report prepared by the staff of IDA and IMF, 15 September 2009, table 1.

³¹ Ibid.

Figure III.3
Debt-service payments as a proportion of export revenues, 1990–2007



Sources: UN/DESA, based on data from Millennium Development Goals Indicators, available at <http://mdgs.un.org>, and World Bank Global Development Finance database.

the effects of a decline in fiscal revenues, many other countries will face greater difficulties in securing public expenditures for development activities unless additional resources are forthcoming. As at March 2009, the debt levels of almost 30 countries exceeded 60 per cent of their GDP.³²

Even countries with less severe debt problems faced problems in rolling over their debt

The crisis has also aggravated the external debt situation of a large number of countries that have not received debt relief and has compromised the progress made under the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI). Even those without serious debt-servicing problems faced problems in rolling over their stock of existing private sector debt.³³

Forty countries are eligible for debt relief under the HIPC Initiative

At the end of July, 40 countries were eligible or potentially eligible for the HIPC Initiative.³⁴ Of these, 26 are receiving full debt relief from the IMF and other creditors by virtue of having reached the completion point, and some of the 9 countries that have reached their decision points are receiving interim debt relief. In 2008 year-end net present value (NPV) terms, the total amount of debt relief available for these 35 countries is estimated at \$85.7 billion, of which \$57.3 billion falls under the HIPC Initiative and \$28.5 billion under the MDRI.³⁵ The cost of the remaining five pre-decision-point HIPCs is estimated at \$17 billion, most of which will be delivered to the Sudan and Somalia. With respect to the MDRI, almost 85 per cent of the total debt relief has already been delivered to the 26 post-completion-point countries. After full delivery of debt relief, it is expected that the debt burden of these 40 countries will be reduced by 80 per cent.

³² International Monetary Fund (IMF), *The Implications of the Global Financial Crisis for Low-Income Countries* (Washington, D. C.: IMF, March 2009), p. 25.

³³ United Nations, *MDG Gap Task Force Report 2009*, op. cit., p. 41.

³⁴ The number of HIPCs declined from 41 to 40 after Nepal withdrew from the debt-relief initiatives in February 2009.

³⁵ International Development Association and International Monetary Fund, loc. cit., tables 2 and 3.

Many of the countries that have not yet completed the requirements for full debt relief share some common challenges (preserving peace and stability, improving governance and the delivery of basic services, for example). Addressing these challenges will require extreme efforts by these countries as well as support from the international community. Another challenge is to ensure that eligible countries receive full debt relief from all their creditors. Progress in the delivery of debt relief by non-Paris Club bilateral creditors, representing 13 per cent of the total cost, remains low. The delivery of debt relief by commercial creditors, representing 6 per cent of the total cost, has improved through significant debt relief provided to two HIPCs receiving interim assistance.

Reducing debt-service payments, however, is not sufficient to avoid the risk of debt distress. The World Bank noted the need to manage expectations of what debt relief can realistically achieve. Debt sustainability analyses show that the debt situations of a number of HIPCs that have reached the completion point remain highly vulnerable to external shocks because many of them continue to be heavily dependent upon commodity exports. Even prior to the global economic crisis, only about 40 per cent of the post-completion-point HIPCs had a low risk of future debt distress, and the number of countries with a high risk of debt distress had increased from one to four.

At the G20 London Summit in April 2009, leaders reached agreement on a number of initiatives to increase the external financing available to developing countries, including a \$1.1 trillion package to meet the immediate financial needs arising from the financial crisis and to boost global economic activity. Through this initiative, the IMF was expected to triple its resources to \$750 billion, but the actual use of these resources has been limited. The Conference on the World Financial and Economic Crisis and Its Impact on Development, held at United Nations Headquarters in New York from 24-26 June 2009, underlined the legitimate right of developing countries, as a last resort, to negotiate agreements on debt standstills to help mitigate the adverse effects of the crisis.

It is also important to highlight the problem of low- and middle-income countries not regarded as HIPCs but with longstanding external debt problems, only a few of whom have managed to address their predicament in the past decade. Many non-HIPCs managed to reduce their reliance on multilateral financing by drawing on private sector credit prior to the 2008 financial crisis, and a large portion of such loans is expected to be renewed in 2009 and beyond. Owing to the higher cost of borrowing, these countries are likely to face difficulties.

Particularly in this period of crisis, it is useful to emphasize the underlying international consensus that servicing external debt should not take precedence over the effort to achieve the MDGs. The international community should therefore avail itself of the opportunity presented by the crisis to address long-neglected deficiencies in external debt arrangements, including the resolution of sovereign debt, as part of the global effort to strengthen the international financial system.

Reconstructing the global financial system

The global scale of the economic crisis is attributable to known deficiencies in the international financial regime which the international community has hitherto been unable to address and which have been proliferating since the breakdown of the Bretton Woods system in 1971. The necessary reforms require difficult international political rearrangements, often in conflict with the commercial interests of the financial sectors of mature

Eligible countries need to receive debt relief from all creditors

Debt relief is not sufficient to achieve debt sustainability

The G20 agreed on a number of initiatives to assist developing countries

Other low- and middle-income countries will face problems in renewing their debt

Servicing external debt should not take precedence over the MDGs

Progress is needed in five key areas

economies. The parties most severely affected by the global financial regime are severely underrepresented in reform discussions. The series of developing country debt crises since the 1980s and the Asian financial crisis in the late 1990s could be regarded as dress rehearsals for the current crisis and as an unheeded warning of the need to reform the international financial system and architecture, including the mandate, scope, governance, responsiveness and development orientation of key mechanisms. There are five key areas in which progress is urgently needed: international financial regulation, multilateral surveillance, IMF lending and resources, the international system of payments and reserves, and governance reforms in the Bretton Woods institutions.

International cooperation on financial regulation

The crisis has again shown the need for international regulations and more transparency

The crisis has demonstrated the urgent need to introduce international regulatory oversight of a globalized financial system, with sufficient transparency for investors and regulators. This would ensure that financial leverage levels do not endanger the stability of the system as a whole and would create less volatile financial flows for innovation, risk-taking and investing in employment, production and development.

In the Declaration on Strengthening the Financial System,³⁶ adopted at the London Summit on 2 April 2009, the G20 countries declared their common intention to reshape regulatory systems so as to identify and take account of macroprudential risks; expand the perimeter of regulation and oversight to all systemically important financial institutions, instruments and markets; mitigate pro-cyclicality in prudential regulation; strengthen capital and risk management; implement new principles on executive remuneration; and improve standards on valuation and provisioning.

Successful reforms require international coordination

In a financially integrated world, where most of the key players have developed into large, complex multilateral firms, such reforms will be successful only if coordinated at the international level. Although of critical importance, the effort to achieve sufficient coordination and harmonization of national regulatory policies is a difficult undertaking, since, in the foreseeable future, most countries will find it difficult to delegate decisions regarding the supervision and regulation of their financial institutions or national financial system to external bodies, thereby giving up national sovereignty over a key issue of economic policy.

Current institutional arrangements remain inadequate

Heretofore, efforts to strengthen cooperation through the deliberations of the Financial Stability Forum (FSF)—recently reorganized following a G20 decision as the Financial Stability Board (FSB)—the Basel Committee on Banking Supervision (BCBS) and colleges of supervisors have proved inadequate in confronting the current financial crisis. Current institutional arrangements for ensuring that national decisions regarding regulation appropriately take into consideration both external and domestic consequences clearly remain inadequate. The effort at the G20 Pittsburgh Summit to agree on compensation standards in the financial sector presents an example of the need to rise above the variety of inconsistencies and incoherence among regulatory systems across countries, which offer potentially dangerous opportunities for arbitrage and evasion. A clear tendency remains to put domestic interests first without considering possible adverse international

³⁶ See, "Declaration on Strengthening the Financial System", The London Summit, 2 April 2009, available at www.g20.org.

spillovers. The difficulties of better aligning national and global interests, as well as other structural, political, cultural and legal constraints, have significantly hampered effective cross-border supervision.

Enhanced cross-border coordination and cooperation must be accompanied by a clear commitment to avoid fragmentation and regulatory protectionism resulting from actions taken at national and regional levels to address the crisis and its aftermath. Nonetheless, the process of building up national (or regional) controls is already under way in many countries. Some observers believe that this has already had adverse international effects resulting in fragmentation of the global financial system. It will likely continue unless much better structures for international cooperation and coordination are developed to ensure a level playing field in global finance.³⁷

The crisis has demonstrated the harm inflicted by regulatory loopholes and regulatory arbitrage. There appears to be an agreement, in principle, that given the national scope of regulation and the global nature of the financial markets, the coordination of regulators should be strengthened in key aspects of prudential regulation. As a first step, the international community must articulate and affirm essential principles governing financial market regulation in all countries and across borders, and provide for continuous oversight of progress in coordination and cooperation.

Another important gap is incompatibility among bank insolvency frameworks, especially in the case of inconsistencies between the home and host countries of financial institutions. There is broad international agreement that existing frameworks do not allow for the orderly resolution of cross-border failures of large complex banking organizations. Current frameworks focus on individual institutions rather than on financial groups or financial systems as a whole, and have proven problematic even at the national level.

No country on its own can establish an effective resolution framework in a globally integrated financial system. At the Pittsburgh Summit, the G20 leaders called for addressing, in an internationally consistent manner, cross-border resolutions for systemically important financial institutions by the end of 2010. This includes the development by financial firms of contingency and resolution plans; the establishment by authorities of crisis-management groups and a legal framework for crisis interventions; more intensive supervision; and additional capital and liquidity requirements for systemically important institutions.³⁸ One of the most important and difficult matters in this regard is burden-sharing.³⁹ To be credible, burden-sharing arrangements should be legally binding and based on objective criteria that ensure an equitable distribution of costs.

Better coordination is also needed to ensure more consistency in depositor and investor protection schemes across countries. Explicit coordination principles should help mitigate destabilizing capital flows, including deposits, from one country to another during periods of market stress and uncertainty. For instance, it has been noted that during the current crisis, the introduction of protection of domestic banks' assets and liabilities with government guarantees by some developed countries puts pressure on less protected systems in neighbouring countries, exposing them to risks of deposit runs. The network

Fragmentation and regulatory protectionism have to be avoided

Bank insolvency frameworks remain incompatible

Better coordination is also needed regarding depositor and investor protection schemes

³⁷ See, for instance, "Seven lessons from the last three years", speech delivered by John Gieve, Deputy Governor of the Bank of England, at the London School of Economics, London, 19 February 2009, available at www.bis.org.

³⁸ See, "Leaders' Statement", The Pittsburgh Summit, 24-25 September 2009, available at www.g20.org.

³⁹ In the case of recent developing country debt crises, for example, the burden fell fully on Governments of debtor countries, even for privately contracted debt.

of government support in advanced countries also puts pressure on emerging-market banks.⁴⁰

Cross-border information-sharing needs to be improved

Cross-border information flows have been inconsistent, lacking both complete data on cross-border risk exposure and an adequate appreciation of systemic connections among financial institutions, thereby providing poor guidance to the management of crisis responses. In this regard, it has been suggested that supervisors in different countries should have prior agreements on the kind of information relevant for systemic stability that all authorities should collect and share among themselves. There should be a system of unambiguous legal obligations and powers to share this information with external authorities.

While there is broad agreement on the need to improve cooperation and communication across regulators, there are quite different views on how international cooperation can be reinforced. The approach of the G20 has been to strengthen existing arrangements by requesting the FSB, with its recently expanded membership, to set standards and the IMF to assess whether national regulation meets these standards. This will expand the surveillance role of the IMF to the hitherto overlooked intersection between national macroeconomic policies and the supervision of individual financial institutions and national financial systems. In the context of the recent performance of its assigned surveillance duties, doubts about the Fund's legitimacy, accountability and effectiveness have been raised.

A more formal global regulatory framework may be needed

The most ambitious alternatives are proposals for new institutions or approaches to regulation implemented through a world financial organization, an international bank charter, and an international insolvency mechanism. According to proponents of a world financial organization, the current informal arrangements comprising numerous bodies, which have sometimes been moving on a divergent, rather than convergent, path and have no legal power, may not be enough. Thus there may be a case for exploring the need for a more formal global regulatory framework, with legal powers of enforcement similar to the World Trade Organization (WTO). The new body would establish principles for prudential supervision, define obligations for its members, appoint independent panels of experts to determine whether countries were in compliance with those obligations, and authorize the imposition of sanctions against countries that failed to comply.

A less ambitious version of the world financial organization proposal is the creation of a global regulatory coordinating council, under the aegis of the FSB.⁴¹ Said council would be mandated to reinforce operational cooperation between the IMF and the FSB and strengthen global efforts towards harmonization and coordination.

An international bank charter could help in assessing risks

A key issue in a cross-border harmonized bank resolution framework is the division of costs among public authorities involved in such efforts. In this regard, there have been proposals for an international bank charter which would spell out the procedures for joint risk assessment, remedial action and burden-sharing across countries. There have also been calls for a universal venue, guided by international law, where cross-border insolvencies of internationally active financial institutions can be administered.

"Colleges of supervisors" are an alternative approach

A less bold approach to cooperation is the "colleges of supervisors" mechanism promoted by the G20. These colleges have been established for all the large complex financial groups that the FSB has identified as being in need of them. The colleges, consisting

⁴⁰ International Monetary Fund, "Initial Lessons of the Crisis for the Global Architecture and the IMF", paper prepared by the IMF Strategy and Policy Review Department, 18 February 2009, p. 7, available at www.imf.org.

⁴¹ Letter to his Excellency Dr. Youssef Boutros-Ghali, Chairman of the International Monetary and Financial Committee, from Charles Dallara, Managing Director of the Institute of International Finance, 13 April 2009, available at www.iif.org.

of home and host supervisors, are collectively responsible for the effective supervision of large cross-border institutions, including assessing risk concentration and major strengths and weaknesses, as well as deciding on firms' permissible activities. One of the key issues on the supervisory college agenda is to agree on concrete steps to codify closer home-host collaboration, including explicit agreement on actions to address vulnerabilities at an early stage. Also, in the absence of the above-mentioned bank charter, colleges could be an arbiter for home and host supervisors on bank resolution.

It is also worth noting that the fragmented nature of domestic regulation in many countries also requires more coordination and cooperation. Indeed, even within national boundaries there remains the potential for jurisdictional conflict and miscommunication between competing laws and regulatory bodies.

Multilateral surveillance and policy coordination

Surveillance remains the key crisis prevention tool of the IMF. But progress still needs to be made in its design and implementation. Since it is indisputable that the global financial crisis requires global solutions, the world economy, now more than ever, needs a credible IMF with a governance structure that is more representative of developing country interests, and one that can exercise strong policy leadership.

IMF surveillance can only be effective to the extent that members are cooperative and responsive in implementing recommendations. Indeed, many of the imbalances that led to the crisis had been identified by the IMF and other international organizations. However, there was a failure to act on available information. The challenge is to ensure that, going forward, the relevant information is used proactively to mitigate future crises.

While the Fund's traditional emphasis has been on exchange rates,⁴² the crisis has pushed macrofinancial and microprudential issues onto centre stage in IMF surveillance. In this regard, more attention should be given to financial risks, including asset price bubbles, leverage, risk concentration in large banks, and hidden or off-balance sheet exposures. A key aspect here is the integration of macroeconomic and financial sector surveillance, the focus on the linkage between the macroeconomy and the financial markets and the soundness of the financial sector of member countries, especially those that are systemically important. The challenge for policymakers at both national and international levels is the lack of an agreed conceptual framework to guide international cooperation on these other, but intimately related, dimensions of policy.

The IMF, as a global institution with substantial analytical capacities, is to play an important role in helping to reach consensus on these issues and in implementing the resulting arrangements. To this end, a joint IMF-FSB early-warning exercise may help establish a less fragmented and more pointed surveillance system. Indeed, the exercise will combine the Fund's macrofinancial expertise with the regulatory experience of the Board to produce a more systematic view of evolving global risks. The final outcome of the early-warning exercise is expected to constitute policy advice for mitigating these risks.

In addition, the Financial Sector Assessment Program (FSAP) of the IMF and World Bank needs to be made more focused, risk-based and forward-looking, and have greater emphasis on external links and spillover effects. As regards FSAP implementation, it is worth noting that all G20 members are committed to participating in the Program.

More coordination may be needed even within individual countries

The design and implementation of surveillance needs to be improved

A broader approach to surveillance is needed

A joint IMF-FSB early-warning exercise may help to streamline surveillance

The FSAP needs to be made more focused

⁴² See *World Economic Situation and Prospects 2009* (United Nations publication, Sales No. E.09.II.C.2), pp. 83-84.

There is an agreement that financial sector surveillance should be embedded more effectively as an element of the Fund's Article IV consultations and its results integrated into the broader macroeconomic surveillance work. Moreover, there has been agreement on the necessity of reassessing the Fund's surveillance mandate to cover the full range of macroeconomic and financial sector policies.⁴³

The macroeconomic implications of fiscal measures need to be evaluated

G20 leaders called on the Fund to assess regularly the actions taken and actions required to revive global growth. It is also important to evaluate the costs and impact of the large fiscal stimulus measures as well as their long-term macroeconomic implications. The peer-review approach announced by the G20 will be serviced by IMF staff, but the enforceability of the outcomes of this makeshift mechanism is still to be tested. For many advanced economies, there is an urgent need for medium-term policy frameworks to anchor expectations and reassure markets of the long-term solvency of fiscal positions.

Moving beyond resolution of the current crisis, enhanced international cooperation should aim at identifying and implementing policies that are conducive to a rebalancing of global sources of growth and to a sustainable reduction of savings-investment gaps, as suggested in chapter I. In this regard, there have been serious concerns that policymakers may be currently sowing the seeds of future boom and bust episodes by taking actions that may slow, or possibly prevent, necessary global adjustments, by providing "too much" demand stimulus.

In this regard, the International Monetary and Financial Committee of the IMF (IMFC) called on the Fund to develop, by the time of its spring meeting in 2010, principles for orderly, cooperative and consistent exit strategies and policies. There is consensus that a premature withdrawal of monetary and fiscal stimuli by individual countries with a view to an "orderly exit" would pose a significant risk. Thus, an exit strategy should retain a counter-cyclical policy framework, with the phasing out of stimulus measures after unemployment rates have come down to acceptable levels.

Enhanced surveillance has to focus on reducing imbalances

The primary long-term goal of enhanced surveillance must be the reduction of global imbalances, including those that contributed to the current crisis. This can only be accomplished if key systemically important countries take a coordinated approach to fiscal and monetary policy with the aim of shifting aggregate demand from deficit to surplus countries.

A political agreement on coordination is part of the solution to the crisis

The current crisis has brought to light important weaknesses in international cooperation and coordination. In this regard, it has been stressed that even where the problems were well understood, there was no agreement on responsibilities or means for enforcing the necessary cooperative actions.⁴⁴ Consequently, it is necessary to build an effective framework for enhanced multilateral surveillance and policy coordination against the backdrop of planned governance reform in the IMF and other global institutions.

Without a political agreement in this area any solution to the present crisis would only be partial and inadequate. Moreover, if such a framework or forum for policymakers having an authority to respond to global systemic concerns is not established, the enhanced resources and mandate of the Fund will likely not be enough to forestall future crises. There is a need to promote an adequate level of coordination, be it under the auspices of the IMF or not, aimed at having mutually compatible policies on fiscal, monetary and exchange-rate issues, including mechanisms to address accountability and enforceability in the application of these policies.

⁴³ Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Washington, D. C., 4 October 2009, available at www.imf.org.

⁴⁴ See, for instance, Amar Bhattacharya, "A Tangled Web", *Finance & Development*, March 2009, p. 42.

At the Pittsburgh Summit, leaders put forward the G20 as the premier forum for international economic cooperation, and launched a Framework for Strong, Sustainable and Balanced Growth aimed at ensuring that the fiscal, monetary, trade and structural policies of their countries are collectively consistent with the Framework's objective, including the reduction of development imbalances. It was also decided that the IMF would assist the G20 members in the mutual assessment of how their policies fit together.

The crisis has shown that international cooperation can be mobilized if the interests of major economic powers are under threat. Indeed, swift and decisive policy actions by G20 countries and, at their request, by multilateral financial institutions might have helped avoid an outright global economic and financial collapse. The G20 has also become a significant locus for multilateral economic discussion, but its effectiveness will be truly tested in the coming global effort to address international imbalances in trade, finance, and the public-private economic mix.

More universal venues for economic coordination and reform, such as the United Nations—particularly in a global system of mechanisms specializing in such distinct areas as trade, development finance and macroeconomic cooperation—could still prove to be indispensable in the long run. But the agility of small groupings such as the G20 is an advantage in a crisis situation. It will be necessary for the G20 process to develop greater legitimacy, especially as it begins to deal with a broader set of issues, including through allowing variable membership configurations depending on the issues under discussion, forging stronger institutional linkages with non-member States and achieving responsiveness of more universal international bodies to G20 decisions.⁴⁵

The ongoing crisis has given new and strong impetus to improving policy coordination on economic and financial issues. National authorities have pronounced a rejection of beggar-thy-neighbour type policies but do not have a secure international context in which to moderate domestic pressures towards unilateral policies. The crisis should be seen as an opportunity to strengthen multilateral collaboration in a significant way. To that end, however, a whole spectrum of world economic governance issues needs to be urgently addressed.

Swift action by the G20 helped avoid an economic collapse

The crisis presents an opportunity to strengthen multilateral collaboration

IMF lending and resources

Since the onset of the crisis, the IMF has been providing large-scale financing to a small group of countries. An important characteristic of new IMF lending arrangements has been their exceptionally large size in relation to the country's quota. The conditions of the recent loans have been fewer and more targeted than in the past. However, these conditions continue to place at their core standard IMF-type elements such as public sector spending reductions and prohibitions on capital-account restrictions whose role in the current situation has raised some concern.

Along with meeting immediate country needs, the Fund has moved to overhaul its lending toolkit and conditionality framework to increase the effectiveness of its crisis prevention and resolution efforts. It has doubled all loan access limits, including those for low-income countries, and the surcharge framework has been simplified.

Moreover, in March 2009, the Flexible Credit Line (FCL), a crisis prevention instrument, was established. The main objective of the FCL is to provide assurance to

The IMF has made changes to its lending toolkit

⁴⁵ See, for instance, statement by the representative of Singapore at the eighth meeting of the Second Committee, United Nations General Assembly, 12 October 2009 (press release GA/EF/3244).

members with strong economic policies and a proven track record of rapid, large and upfront access to Fund resources in case of need, with no ex post conditionality. Colombia, Mexico and Poland have already signed up for this new facility for an amount totalling \$78 billion. The Fund has also indicated that it is committed to providing larger amounts and more upfront financing across a wide range of its facilities.

For other middle-income countries which may need a large precautionary arrangement, but which have yet to go through policy adjustment, there is a new High-Access Precautionary Arrangement (HAPA), also characterized by large and frontloaded access, but imposing ex post performance requirements. The existence of two precautionary facilities has raised some concerns, however, as the choice between an FCL and a HAPA would inevitably require potentially controversial judgements regarding the strength of underlying policies, economic fundamentals and the track record of member countries, often leading to arbitrary differentiations among them. This conundrum exposes the underlying deficiency of an approach that is meant to provide unconditional financing for truly external shocks, but access to which is based on meeting a set of prior conditionality indicators derived from standard IMF criteria which have not proven robust in previous episodes (such as in the Asian crisis).

The current arrangements can only be a first step

The introduction of the FCL and HAPA can only be seen as a first step in the effort to prevent and resolve crises, if even that, since the instruments being introduced take as given the existing international regulatory regime over private capital flows. For example, one could view these enormous publicly provided resources as an implicit guarantee for private sector investments in emerging markets, thereby creating an unacceptable moral hazard. The IMFC, at its twentieth meeting on 4 October 2009, asked the Fund, by the time of the 2010 Annual Meetings, to study and report on the latter's future financing role, including the possibility of offering credible alternatives to self-insurance. The crisis has highlighted the need for very large liquidity buffers to deal with fast and sizeable capital market shocks. Accordingly, a much larger precautionary facility that reduces the need for self-insurance against crisis and is available for a vast majority of countries may be needed. A more representative and legitimate IMF could become an important provider of reliable emergency financing, gradually taking over the role of international lender of last resort that is now assumed by some of the major national central banks through swap arrangements.

Many of the recent changes in lending facilities have been focused on precautionary arrangements. However, there is also scope for further innovation with regard to how resources in drawing programmes are deployed. Amidst unprecedented crisis, it is important to take a fresh look at the ways in which the IMF provides its support.

The focus of conditionality has shifted

As of 1 May 2009, structural performance criteria were discontinued for all IMF loans, including programmes with low-income countries. The focus of conditionality is shifting to an ex ante and review-based approach. Structural reforms will continue to be part of IMF-supported programmes, but only when they are considered critical to a country's recovery, in contrast to the previous approach, which always included a panoply of structural reform conditionalities, including requirements unrelated to the problems at hand. As identified in many studies, including research by Bretton Woods institutions' staff,⁴⁶ structural reforms tend to enhance pro-cyclicality, while macroeconomic reforms have a deflationary bias, constricting public investment and social expenditures critical to sustainable long-term development.

⁴⁶ See, for example, the background report dated 6 April 2009, entitled "Fiscal Policy for Growth and Development: An Interim Report", submitted to the Development Committee Meeting of the IMF and the World Bank on 23 April 2009, available at [http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003\(E\)-FiscalPolicy.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003(E)-FiscalPolicy.pdf).

Strong, credible policy frameworks are necessary, and there is an urgent need for greater clarity regarding which policies are actually effective, given that the current situation has raised many questions about the standard framework. In fact, there is now often a stigma attached to seeking support from the Fund, signalling underlying policy weaknesses which can be exacerbated in the course of the Fund's programme. Reducing this political stigma is considered vital to increasing use of the Fund by its members, thus enabling it to play a greater role in recovery from the global crisis.

Reducing the policy stigma of seeking IMF support is considered vital

IMF support to developing countries

For example, despite pronounced intentions, many recent IMF country programmes contain pro-cyclical conditions that can unnecessarily exacerbate an economic downturn in a number of developing countries. Indeed, amid sharply falling global demand, the Fund has been advocating belt-tightening for many developing programme countries. At the same time, it has been praising advanced economies for their unprecedented efforts in borrowing and spending their way out of recession. The IMF should expand the use of its resources to help support counter-cyclical measures in those developing countries that have sustainable public finances in the medium-term but are impeded in this effort by adverse market conditions. This would be consistent with ongoing concerted efforts to stimulate global demand.

Counter-cyclical measures should be emphasized

During the global slowdown, many countries may need to borrow more to support output recovery and maintain social spending. To ensure that the developing countries are not unduly constrained by policy arrangements from taking on more debt to support recovery efforts, the IMF and the World Bank are reviewing the Debt Sustainability Framework for Low-Income Countries (DSF), as had been requested by the G20. The DSF should be sufficiently flexible to take into account each country's circumstances while still performing its role in preventing a renewed build-up of unsustainable debt burden.

The IMF and the World Bank are reviewing debt sustainability

There have also been suggestions for the IMF and other international financial institutions to take an unorthodox stance and use their financing to address problems in the corporate and banking sectors, including support for bank recapitalization or facilitation of the rollover of private external debt.⁴⁷ The Fund's financing of member Governments has traditionally been used for the replenishment of foreign-exchange reserves, sovereign debt repayment or intervention in the foreign-exchange market. However, in the current crisis, Governments and their central banks, in both developed and developing countries, have used foreign-exchange reserves and new borrowing to help their domestic financial institutions and corporations repay international creditors. With the ongoing globalization of finance, these needs are likely to increase further. The IMF should play an important role in meeting them.

There is a consensus that the Fund's lending to low-income countries should be more flexible in the light of long-recognized diverse country needs and growing exposure to global volatility. In July 2009, the IMF announced a new concessional lending framework to enhance its usefulness to low-income countries. In addition to the doubling of average loan access limits for low-income countries mentioned above, the Fund's concessional lending capacity was boosted to up to \$17 billion through 2014, of

IMF lending needs to be more flexible

⁴⁷ See, for instance, statement by Alistair Darling, Chancellor of the Exchequer, United Kingdom, at the nineteenth meeting of the International Monetary and Financial Committee, International Monetary Fund, Washington, D. C., 25 April 2009, available at www.imf.org.

which \$8 billion is to be delivered in the first two years. This exceeds the call by the G20 for \$6 billion in new lending over two-to-three years. The new measures include a new unified facility for low-income countries under a new Poverty Reduction and Growth Trust (PRGT) fund. The framework comprises three new concessional lending facilities: an Extended Credit Facility (ECF), successor to the PRGF, to provide medium-term support; a Stand-by Credit Facility (SCF), similar to the Stand-By Arrangement, to address short-term and precautionary needs; and a Rapid Credit Facility (RCF), to offer emergency support with limited conditionality. In addition, interest payments for low-income countries have been temporarily suspended.

G20 leaders pledged to increase the lending capacity of the IMF

In the context of lending reform and sharply higher demand for Fund financing, G20 leaders pledged to triple the lending capacity of the IMF to \$750 billion and, as mentioned above, at least double its capacity for concessional lending to low-income countries. To bolster the Fund's resources as quickly as possible, it was decided to negotiate temporary bilateral credit arrangements with the IMF totalling \$250 billion, to increase New Arrangements to Borrow (NAB) by up to \$500 billion and to expand the participation in NAB to additional, financially strong IMF members. There was also an agreement to implement the 2008 quota agreement as quickly as possible—thereby increasing IMF quota resources by 12 per cent—and complete the next review of IMF quotas by January 2011, accelerating the process by two years.

Fund borrowing cannot replace quota increases

Bilateral borrowing arrangements and the expansion of NAB are likely the most viable options for mobilizing liquidity in a timely manner. However, they are considered by many IMF members to be a temporary bridge to a permanent increase of resources through a general quota review. They are also potentially harmful in that they could create conflicts of interest for an institution mandated to undertake surveillance over all members. Consequently, Fund borrowing cannot be seen as a substitute for a substantial quota increase in terms of maintaining IMF decision-making structure or legitimacy. Over the medium term, it is important from both governance and balance-sheet perspectives that the quota be restored as the primary basis of IMF lending. The next review of IMF quotas, envisaged for January 2011, comes at an appropriate moment in this regard.

The global reserve system

The G20 decided on a general SDR allocation

In April 2009, the G20 decided on a general special drawing rights (SDR) allocation by the IMF equivalent to \$250 billion as part of the package to raise official lending capacity in response to the crisis. By so doing, the world leaders, for the first time since the late 1960s, recognized the need to significantly boost international liquidity using an international reserve unit. The proposed general allocation was approved by the Fund's Board of Governors and came into effect in August 2009. Also, in August 2009, the Fourth Amendment to the IMF Articles of Agreement adopted in 1997—which corrects for the fact that countries which joined the Fund after 1981 have never received an SDR allocation—entered into force. The special one-time allocation of about \$33 billion was made in September 2009. With the two fresh allocations totalling roughly \$283 billion, the outstanding stock of SDRs increased nearly tenfold from about \$33 billion to about \$316 billion.

The crisis has illustrated the deficiencies of the status quo

The ongoing financial crisis has brought to the fore the deficiencies of the present international monetary system, in which a national currency (the United States dollar) serves as a dominant source of international foreign-exchange reserves. These deficiencies include growing global imbalances, exchange-rate instability and the possibility

of an erosion of confidence in the dollar as a reserve currency (see chapter I). The spread of greater exchange-rate flexibility did not produce changes that reduced trade and financial imbalances; in fact, it contributed to the inherent instability of the system. Exchange-rate adjustments were not quantitatively sufficient and often progressed in the wrong direction, owing to the fact that the United States dollar, as a reserve currency, serves as a benchmark for many other currencies and an anchor for international asset prices.

In the era of globalization, the use by all countries of a widely accepted national reserve currency has its clear benefits owing to network externalities. However, the costs of such an arrangement in terms of systemic instability may have started to exceed the benefits. Similarly, the costs to the United States as supplier of global reserves may also be rising. Increased imbalances have had an adverse effect on United States domestic demand and on external demand for United States products as well as, more generally, on the country's potential ability to maintain economic policy autonomy.

There have been suggestions for a move away from the almost exclusive reliance on the United States dollar towards a system based on multiple, competing national reserve currencies. However, the experience of the interwar period specifically suggests that such a system adds another element of instability: that associated with exchange-rate volatility among currencies used as reserve units, stemming from the possibility of sharp shifts of demand from one international currency to the other, since they are likely to be close substitutes.⁴⁸ In addition, such a move would not solve the inherent inequity in the current system, as reserve assets would still be provided by industrial countries. Moreover, developed countries issuing reserve currencies are likely to account for an increasingly limited share of the world economy. Hence, the demand for international reserves will likely grow faster than the capacity of these countries to provide a smooth supply.

Discussions concerning wider use of a truly international currency have been gaining momentum. The international community should seize this opportunity to start deliberations on the feasibility and desirability of the creation of a new, more stable and equitable international monetary system. While, unlike in the late 1960s, the provision of global liquidity is not an issue, the current problems are associated with the control of global liquidity, and significant equity issues regarding access by developing countries to such liquidity.⁴⁹ Moreover, a system based on a truly global reserve currency would create a more equitable method of sharing the seigniorage derived from providing global liquidity.

The introduction of a full-fledged international reserve currency, based, for instance, on the proposal by John Maynard Keynes, may take a long time as it requires extraordinary political will, vision and courage, all of which are still lacking. In this regard, it has been argued that a more realistic way of reform may be to broaden existing SDR arrangements which, perhaps, over time could evolve into a new and widely accepted world reserve currency.⁵⁰

Making SDR issuance automatic and regular could be a first step forward. It has been suggested that the size of the issues could be linked to the estimated additional demand for foreign-exchange reserves resulting from the growth of the world economy. There have

Using a multicurrency system could add further instability

A truly global reserve currency would be more equitable

A more realistic approach may be to broaden SDR arrangements

⁴⁸ See, for instance, Barry Eichengreen, "Out of the Box Thoughts about the International Financial Architecture", IMF Working Paper, No. WP/09/116, May 2009, p. 10, available at www.imf.org.

⁴⁹ For an extensive discussion of the global reserve system and possible ways to reform it, see, for instance, Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, pp. 92-102, available at www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf.

⁵⁰ Zhou Xiaochuan, "Reform the international monetary system", 23 March 2009, available at www.bis.org.

also been calls to issue SDR in counter-cyclical fashion to finance world liquidity and provide official support to developing countries during crises. One version of the proposal to use SDR in a counter-cyclical manner envisages the development of an appropriate mechanism to withdraw SDR should global liquidity become excessive or inflationary. It is worth noting that the procedure under which countries holding 85 per cent of the IMF voting power must agree before SDRs can be issued may not be appropriate if the Fund were authorized to provide additional SDR liquidity in periods of shortage. Rather, it must be able to act more like a global central bank and international lender of last resort.

SDR allocation is closely linked to the reform of IMF quotas

Because the current mechanism of SDR allocation is based on IMF quotas, such new allocations of SDR would provide developing countries with additional liquidity of only about \$110 billion. This suggests that the issue of the SDR allocation should be closely linked to the reform of IMF quotas. Besides, as not all members need an increase of their international reserves, the Fund should explore mechanisms to redistribute SDR to countries most in need.

A revival of the substitution account may need to be considered

It has been suggested also that the international community revive the idea of the substitution account put forward in 1971. Under this proposal,⁵¹ official dollar holders could deposit part of their reserves in a special account in the IMF denominated in SDRs. The centralized management of a part of member countries' reserves by the IMF would help promote both a greater role for the SDR as a reserve currency and more effective reserve management at the global level, as it would allow central banks to diversify out of dollars without causing sharp exchange-rate swings and, probably, use some excessive reserves for domestic development. A more ambitious version of the proposal calls for an open-ended SDR-denominated fund set up by the IMF, allowing subscription and redemption in the existing reserve currencies by various investors as desired. This arrangement is thought to form the basis for promoting the development of SDR-denominated assets and partially allowing the management of global liquidity in the form of existing reserve currencies.

SDRs would need to be commercialized

It is widely recognized that making the SDR an attractive unit in which to hold central bank reserves requires deep and liquid markets in SDR claims. To achieve this, the issuance and use of SDRs by the IMF, Governments, banks and non-financial firms need to reach a certain critical mass. In other words, it will be necessary to overcome the coordination problem (prospective issuers should have evidence that others would act in like manner). In the past, all attempts to commercialize SDR have been unsuccessful.

A settlement system would need to be established between SDRs and national currencies

Another important issue is a settlement system between the SDR and national currencies to make the unit an acceptable means of payment in international trade and financial transactions. Such a system should be able to facilitate the direct exchange of SDR claims not only into dollars but into all constituent currencies. In order to accommodate the expected increase in the volume of SDR transactions resulting from new allocations, the IMF has called for an expansion of the capacity of voluntary arrangements to ensure adequate liquidity in the SDR market. Several countries, including China and the United States, have already committed themselves to establishing a new arrangement or expanding the capacity of their existing arrangements in the light of the new allocations.

To gain global prominence, the number of currencies that constitute the SDR would have to increase

Furthermore, SDRs are currently valued against a basket of currencies consisting of the euro, the Japanese yen, the pound sterling and the United States dollar. To gain

⁵¹ Peter B. Kenen, "Revisiting the Substitution Account", paper presented at the conference "Towards a World Reserve System" held by the Initiative for Policy Dialogue of Columbia University on 6 November 2009.

global prominence, the number of constituent currencies of the SDR would have to be increased to include monetary units of both developed and developing countries.

Global governance and the Bretton Woods institutions

Strengthening the resource base of the Fund and improving its lending toolkit to address the global crisis should proceed together with longer-term reforms to boost its governance and legitimacy. The IMF needs a more representative, responsive and accountable governance structure to ensure that it remains at the centre of the international monetary system and reflects the realities of the twenty-first century. The reform of governance is therefore a necessary prerequisite for all other changes involving the role of the Fund.

The changes in voting power have thus far been insignificant compared with the changes that have occurred in the global economy. The 2008 quota and voice reform will basically lead to a realignment of existing shares primarily through a redistribution among the group of emerging market and developing countries, a step back from the agreement of September 2006, which premised these reforms in terms of increasing the overall voice of developing countries. The understanding that providing ample voting weight to potential users of Bretton Woods institutions' resources would help guarantee these institutions' effectiveness—a principle enshrined in the original 1944 allocation of voting weights when European countries were the prospective users—should guide vote reallocation and reforms in voting procedures. Consequently, the next realignment of quotas in favour of emerging market and developing countries should go far beyond the initial modest agreement achieved during the 2008 Spring Meetings, which has yet come into force.

IMFC and the Development Committee agreed to shift at least 5 per cent of aggregate quota shares in the IMF and 3 per cent in the World Bank from developed to developing and transition countries at the next quota review, scheduled to be completed in January 2011. Many developing countries, however, emphasized that a shift of at least 7 per cent in the IMF and at least 6 per cent in the World Bank has been committed to by the G20 Pittsburgh Summit and should not be further delayed.⁵²

To further democratize the voting procedure and ensure that decisions affecting key aspects of the institution have the support of the majority of members, a proposal has been made to amend the Articles of Agreement to lower the voting threshold on critical decisions from 85 per cent to between 70 and 75 per cent. To better balance the interests of large and small countries, consideration should also be given to applying double majority mechanisms to a wider range of decisions. At present, a double majority (support by three fifths of the members having 85 per cent of the total voting power) is required to amend the Articles of Agreement.

Another important issue is the composition of the Executive Board. In this regard, there have been proposals to reduce the size of the Board from 24 to 22 chairs by 2010 and to 20 chairs by 2012, while preserving the existing number of emerging market and developing country chairs.⁵³

The IMF needs a reformed governance structure

Changes in voting power have so far been insignificant

There is a proposal to lower the voting threshold on critical decisions

⁵² Communiqué of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development, Istanbul, Turkey, 3 October 2009, available at www.g24.org.

⁵³ Statement by Timothy Geithner, Secretary of the United States Treasury, at the nineteenth meeting of the International Monetary and Financial Committee, Washington, D. C., 25 April 2009, available at www.imf.org.

A more democratic distribution of voting power on the Board has been called for

The objective of ensuring greater involvement of the Fund's Governors in providing strategic direction to the IMF and in increasing its accountability can only be achieved under a more democratic distribution of voting power on the Board. As a possible immediate step, there have been calls to transform the IMFC into a council, as envisaged by Article XII of the Articles of Agreement. Some consider that a council, consisting of ministers and governors, would provide a forum for coordination and take strategic decisions critical to global stability.⁵⁴

It has been emphasized, however, that before activation of a council, a substantial and far-reaching reform of quota and voice should be accomplished. Otherwise, with prevailing voting shares, the developing countries would have even less influence in the IMF. Indeed, unlike the present consensus-based IMFC, the council's decision-making rule, as contained in the Articles of Agreement, would be the same as that of the Executive Board.⁵⁵

The G20 has agreed on the appointment process for leadership positions

The G20 has also agreed that the heads and senior leadership of the international financial institutions should be appointed through an open, transparent and merit-based selection process, with due regard to gender equality and geographical and regional representation. In order to ensure the legitimacy of the Fund and the World Bank as truly global institutions, it is important to achieve greater diversity among staff members and to avoid the disproportionate representation of only a few specific regions.

World Bank reform should be even more ambitious

It has been claimed that the reform of the World Bank should be even more ambitious and, given its development mandate, not simply mimic the IMF in all respects. For instance, in its report on World Bank governance,⁵⁶ a high-level commission led by former Mexican President Ernesto Zedillo suggested that the historic link between IMF quotas and International Bank for Reconstruction and Development (IBRD) shareholding and voting power allocation should be abandoned, and called for the development of Bank-specific principles and formulas for shareholding. The Commission also recommended that the balance in voting power in the Bank should be evenly split between developed and developing countries.

⁵⁴ See Final Report of the Committee on IMF Governance Reform, 24 March 2009, available at <https://www.imf.org/external/np/omd/2009/govref/032409.pdf>.

⁵⁵ International Monetary Fund, "Executive Board Report to the IMFC on Reform of Fund Governance", 3 October 2009, available at www.imf.org.

⁵⁶ See, "Repowering the World Bank for the 21st Century", Report of the High-Level Commission on Modernization of World Bank Group Governance, October 2009, available at www.worldbank.org.