

Statement to the High-Level Policy Dialogue with the Heads of International Financial and Trade Institutions on behalf of the Committee for Development Policy (CDP)

by

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The need for a development-supportive international financial architecture to compensate developing countries for external shocks

Mr. President, distinguished delegates and representatives of international financial and trade institutions,

As Chairman of the Committee for Development Policy (the CDP), I am honored to be able to participate in your deliberations on the current developments in the world economy.

External shocks, transmitted through the trade balance and financial external accounts, usually have large negative effects on the developing economies, especially on overall growth. The initial effects on key macroeconomic and social variables feed across the entire economy, through reduced government spending and private investment, lower wages, higher unemployment and therefore greater poverty, thus producing negative social and economic effects. The development potentiality of these countries becomes underutilized. That is a huge waste of resources. Furthermore, adverse economic shocks can impede or delay progress in achieving the MDGs.

The CDP therefore stresses the need for a development-friendly international financial architecture to provide adequate counter-cyclical official liquidity to low- and middle-income economies when they become adversely affected by external shocks, arising from the international economy, particularly trade and finance, as well as unforeseen natural disasters.

There is a great urgency to improve existing compensatory financing mechanisms and/or design new ones where gaps exist, as recorded in IMF research and of the Independent Evaluation Office reports. This urgency arises, first, from the fact that the global economic outlook has turned gloomy in 2008-2009 and that developing countries are likely to be highly vulnerable to a slowdown in developed economies. Second, the need for action has become more

pressing given major increases in the price of oil and foodstuffs, which have affected countries that are net importers of those commodities and have already provoked a great deal of social discontent in several nations.

In recent years, some countries have built cushions of reserves and fiscal resources as a buffer (or “self insurance”) against external shocks. However, high levels of reserves carry large burdens mainly in terms of the opportunity costs of productive investment foregone and direct financial losses stemming from relatively low interest earnings on reserve assets. The decline of the United States dollar has further added to financial costs of holding reserves mostly held in dollar-denominated assets.

Mr President,

Official compensatory flows can play a crucial role in avoiding unnecessary, inefficient, costs to developing countries by reducing the need to hold such high levels of reserves and – more importantly – by helping to avoid recessive adjustment; that is, adjustment that goes beyond that required for recovering real macroeconomic equilibria. Excessive adjustments, which have been quite frequent, lead to underutilize and to discourage potential development. In this regard, improved compensatory flows can potentially be a very effective mechanism to protect economic growth and incomes of poor people in affected countries.

There are currently a number of major compensatory financing mechanisms, which are however, either limited in coverage and volume, too narrowly defined, access comes too late or subject to inadequate conditionality, given the nature of external shocks. Diverse facilities are examined in the full 2008 Report and a technical document of the CDP.

Mr. President,

In view of the worsening global economic outlook, its implications for developing countries and the inadequacy of existing compensatory finance instruments, the Committee stresses the need for a reformed compensatory financing architecture to provide official liquidity and aid to developing countries suffering the negative impact of external shocks.

How to finance a significant improvement in the volume and quality of compensatory financing? The Committee considered that reinitiating issues of SDRs, that special international currency that the IMF can issue, could be

directed to finance a significant increase in the availability of compensatory financing. The present prospects of downward adjustment of economic activity and financial turmoil represent an appropriate context for a new allocation of SDRs, with a counter-cyclical role, with a view to cautiously and gradually progress in the direction of a truly international currency of reserve. In this regard, the process of allocation of 22 billion SDRs, approved by member countries of the IMF in 1997, by now ratified by 133 countries but still short of the minimum of 85 per cent of the quotas, should be urgently completed.

The Committee recommends that the reform of the existing compensatory financing mechanisms of the IMF should be significantly simplified because existing schemes are too numerous and complex. All compensatory facilities should have the attributes of speedy disbursement, scale fully proportionate to the external shocks, and low conditionality to maximize the beneficial impact on the recipient countries.

Thank you