

Chapter III

International finance for development

Financing for development is inherently linked to the global environment. While the international community has taken steps to strengthen the global financial system through regulatory reforms—as contained in the internationally agreed Basel III framework, the United States Dodd-Frank Wall Street Reform and Consumer Protection Act and other new regulations implemented elsewhere—these reforms do not adequately address risks in the international financial system, including their impacts on developing countries.

Volatile capital flows originating in the developed economies continue to threaten boom and bust cycles in developing countries. The sovereign debt crisis in Europe and the uneven global recovery have led to heightened risk aversion, which has increased the volatility of private capital flows. A growing liquidity squeeze in the European interbank market has impacted cross-border interbank flows. At the same time, official development assistance (ODA) and other forms of official flows are being affected by greater fiscal austerity and sovereign debt problems in developed countries. Similar to private flows, aid delivery has been pro-cyclical and volatile. The effectiveness of development finance is also severely hindered by shortcomings in international cooperation pertaining to increasing ODA, as well as by the lack of adequate mechanisms for resolving sovereign distress.

Reforms of the international financial system should focus on reducing risk and volatility associated with both private and official flows. Mechanisms to this end, such as improved regulations and reforms to the international reserve system, are crucial to maintaining policy space for developing countries and ensuring adequate financing for development.

This chapter discusses the current global issues associated with the international financial system and their impact on financing for development.

Private capital flows and macroeconomic imbalances

Managing the macroeconomic volatility induced by private financial flows is a major challenge for emerging market and developing country policymakers. Waves of capital inflows in excess of an economy's absorptive capacity, or highly speculative in nature, complicate macroeconomic management and carry risks for financial and economic stability. They may lead to exchange-rate overshooting, credit and debt bubbles, inflation and asset price bubbles. More importantly, there is a risk of sudden stops and withdrawals of international capital due to heightened risk aversion, which contribute to spreading financial crises.

Policymakers in many developing countries have responded to these risks by increasing the accumulation of international reserves as a form of “self-insurance”. However, this has had the effect of exacerbating global imbalances. Furthermore, the strategy of building up international reserves is a costly one, particularly in terms of the opportunity cost of forgone domestic investment. A large share of international reserves is invested in low-yielding (yet considered safe) United States Treasuries, implying a net transfer of

Recent reforms to the international financial system do not adequately address risks

Volatile capital inflows complicate macroeconomic management

resources from poorer countries to wealthier ones. Policymakers in many developing and emerging market countries have thus begun to look to capital-account regulations to manage volatile inflows and increase domestic policy space.

Trends in private capital flows

Private capital flows continue to be highly volatile

Over the past several years, international capital flows to developing countries have been characterized by extreme volatility. The collapse in capital flows during the global financial crisis was followed by a renewed surge in inflows in 2010. Capital inflows began to fall again in September 2011, as growing fears among portfolio investors over the sustainability of public finances in Europe gave rise to a general “flight to safety”. Overall, the latest figures indicate that net private capital flows to developing countries amounted to \$482 billion in 2010 and are forecast to total about \$575 billion in 2011, about half of their peak level of 2007, as discussed in chapter I.¹ However, aggregate numbers on net flows mask differences in the types of inflows and risks, additional risks from derivatives, as well as differences across regions and countries (see table III.1).

The data on private capital flows is generally divided into three categories: foreign direct investment (FDI), portfolio flows and other flows such as cross-border interbank lending. As shown in chapter I, figure I.5, FDI is the largest capital inflow with the lowest volatility. Lower relative volatility of FDI is in large part because FDI, especially greenfield direct investment, tends to have longer-term investment horizons, and be attracted by factors such as high growth rates, cheap asset prices, rule of law and strong macroeconomic fundamentals. On the other hand, short-term flows, including many forms of portfolio investment and cross-border interbank lending, tend to be attracted to developing countries because of high relative short-term interest rates, which often outweigh longer-term fundamentals.

Private capital flows are subject to both short- and medium-term fluctuations

Capital flows to developing countries are not only subject to short-term volatility, but also to medium-term fluctuations, reflecting the successive waves of optimism and pessimism that characterize financial markets. These fluctuations are reflected in the cyclical pattern of spreads, which narrow during booms and widen during crises, shorter maturity of financing during crises and variations in the availability of financing.

International capital flows are also dependent on economic conditions in developed countries. In particular, there is evidence that international flows are highly correlated with global risk aversion.² Although the evidence on the impact of global liquidity on total capital flows is more ambiguous, short-term private flows, such as cross-border interbank lending, seem to be particularly responsive to liquidity and interest rates.³ When interest rates are low, international investors look to invest abroad in search for higher yields. On the other hand, during periods of tight liquidity, banks often reduce lending abroad to deal with liquidity shortages at home.

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- 1 Data in the text refer to the “net net” concept of capital flows, which is measured as “net inflows minus net outflows”, according to balance-of-payments definitions. Cited numbers are from the International Monetary Fund (IMF), World Economic Outlook database, September 2011.
 - 2 Kristin J. Forbes and Francis E. Warnock, “Capital flow waves: surges, stops, flight, and retrenchment”. NBER Working Paper, No. 17351 (Cambridge, Massachusetts: National Bureau of Economic Research, August 2011), finds that flows are highly correlated with global volatility.
 - 3 Bank for International Settlements (BIS), “Global liquidity—concept, measurement and policy implications”, CGFS Publication, No. 45 (Basel, Switzerland: Committee on the Global Financial System, November 2011).

Table III.1
Net financial flows to developing countries and economies in transition, 1998-2012

Billions of dollars							
	Average annual flow		2008	2009	2010	2011 ^a	2012 ^b
	1998-2001	2002-2007					
Developing countries							
Net private capital flows	56.8	160.9	176.5	350.6	404.5	522.7	528.7
Net direct investment	153.5	204.6	360.6	237.7	279.7	364.0	384.5
Net portfolio investment ^c	-5.0	-58.4	-94.2	28.5	46.8	-76.4	-84.5
Other net investment ^d	-91.7	14.7	-89.9	84.4	77.9	235.1	228.7
Net official flows	-12.9	-74.3	-125.4	14.6	47.7	-132.4	-147.8
Total net flows	43.9	86.6	51.2	365.1	452.2	390.4	380.9
Change in reserves ^e	-83.0	-534.0	-786.3	-691.5	-943.3	-1116.6	-1074.2
Africa							
Net private capital flows	10.4	14.9	13.3	26.1	19.0	38.3	51.1
Net direct investment	12.7	25.2	51.4	46.1	35.0	40.9	46.1
Net portfolio investment ^c	-0.3	0.5	-43.0	-18.0	-6.1	-7.9	-1.6
Other net investment ^d	-2.0	-10.8	4.9	-2.0	-9.9	5.3	6.6
Net official flows	-1.7	-4.5	9.0	22.5	32.0	11.4	17.0
Total net flows	8.8	10.4	22.4	48.6	51.0	49.6	68.1
Change in reserves ^e	-7.2	-46.2	-74.0	2.3	-29.7	-49.9	-46.5
East and South Asia							
Net private capital flows	-9.4	101.5	21.3	273.7	298.7	324.5	314.5
Net direct investment	62.7	101.8	154.9	68.3	140.7	156.4	152.8
Net portfolio investment ^c	5.9	-25.7	-42.2	47.5	41.3	-43.6	-72.3
Other net investment ^d	-77.9	25.3	-91.4	157.9	116.7	211.7	233.9
Net official flows	0.9	-26.5	-30.4	-5.6	-5.4	-58.4	-71.1
Total net flows	-8.5	75.0	-9.1	268.1	293.3	266.0	243.4
Change in reserves ^e	-75.5	-368.2	-528.8	-650.9	-708.7	-823.7	-856.1
Western Asia							
Net private capital flows	8.1	17.3	87.0	68.1	49.7	39.7	63.8
Net direct investment	6.9	25.2	58.1	55.9	32.4	40.1	48.0
Net portfolio investment ^c	-6.9	-24.8	10.2	14.7	0.9	-21.1	-9.6
Other net investment ^d	8.1	16.8	18.7	-2.5	16.4	20.7	25.4
Net official flows	-18.1	-33.9	-105.5	-43.6	-25.6	-119.1	-123.5
Total net flows	-10.0	-16.6	-18.5	24.5	24.1	-79.4	-59.7
Change in reserves ^e	-2.6	-73.6	-133.2	6.1	-101.7	-123.0	-109.3
Latin America and the Caribbean							
Net private capital flows	47.6	27.2	54.9	-17.3	37.1	120.3	99.3
Net direct investment	71.2	52.3	96.1	67.4	71.7	126.7	137.6
Net portfolio investment ^c	-3.7	-8.5	-19.2	-15.7	10.7	-3.8	-1.0
Other net investment ^d	-19.9	-16.6	-22.1	-69.0	-45.3	-2.6	-37.3
Net official flows	6.0	-9.3	1.5	41.2	46.7	33.8	29.7
Total net flows	53.6	17.9	56.4	24.0	83.8	154.1	129.0
Change in reserves ^e	2.3	-45.9	-50.4	-48.9	-103.3	-120.0	-62.4

Table III.1 (cont'd)

	Average annual flow		2008	2009	2010	2011 ^a	2012 ^b
	1998-2001	2002-2007					
Economies in transition							
Net private capital flows	-7.5	51.7	-77.6	-50.2	-23.7	-15.0	12.1
Net direct investment	6.0	19.7	60.4	22.4	9.8	33.6	36.3
Net portfolio investment ^c	-1.4	6.2	-31.9	-9.9	9.8	6.9	9.7
Other net investment ^d	-12.0	25.9	-106.1	-62.7	-43.3	-55.6	-33.9
Net official flows	-2.5	-9.9	-10.0	49.3	11.5	12.3	18.2
Total net flows	-10.0	41.8	-87.6	-0.9	-12.2	-2.8	30.3
Change in reserves ^e	-8.5	-82.6	30.0	-11.8	-51.8	-95.9	-83.3

Source: International Monetary Fund (IMF), World Economic Outlook database, September 2011.

Note: The composition of developing countries above is based on the country classification located in the statistical annex, which differs from the classification used in the World Economic Outlook.

a Preliminary.

b Forecasts.

c Including portfolio debt and equity investment.

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

e Negative values denote increases in reserves.

Foreign direct investment (FDI)

As shown in chapter I, FDI in developing countries has tended to be more stable and geared towards the longer term than other types of private capital flows. However, FDI remains concentrated in a few regions and countries. Approximately 70 per cent of FDI is invested in East and South Asia and Latin America and the Caribbean. Almost 90 per cent of FDI in East and South Asia is in China and India, while 50 per cent of FDI in Latin America and the Caribbean is invested in Brazil.

FDI has become increasingly important in the least developed countries

FDI is becoming increasingly significant in least developed countries (LDCs). In recent years, FDI flows have become larger than bilateral ODA to LDCs as a group, with the major share of FDI to LDCs taking the form of greenfield projects. However, FDI inflows to the LDCs accounted for only 5 per cent of FDI inflows to the developing world in 2010.⁴ In addition, the distribution of FDI flows among LDCs remains uneven, with over 80 per cent of the capital going to resource-rich economies in Africa.

In regions with greater proportions of FDI, there is growing evidence that FDI has become more financialized, with less investment in greenfield direct investment and more investments in financial companies or in intracompany debt.⁵ Some items recorded as financial sector FDI can disguise a build-up in intragroup debt in the financial sector, which has a risk profile that is more akin to debt than FDI. Similarly, privatizations and mergers and acquisitions are categorized as FDI, even though they often represent an ownership transfer rather than new investment. In fact, during the recent crisis, countries with larger stocks of debt liabilities or financial FDI fared worse than those with larger stocks of greenfield investment.⁶

⁴ United Nations Conference on Trade and Development (UNCTAD), "Foreign direct investment in LDCs: lessons learned from the decade 2001-2010 and the way forward", (Geneva, May 2011).

⁵ UNCTAD, *World Investment Report 2011: Non-Equity Modes of International Production and Development* (United Nations publication, Sales No. E.11.II.D.2).

⁶ Jonathan D. Ostry and others, "Managing capital inflows: what tools to use", IMF Staff Discussion Note, SDN11/06 (Washington, D.C., April 2011).

In this regard, it has been claimed that the proportion of short-term and volatile flows in FDI has increased, and that part of the growth in FDI flows during the past two years has been made for the purpose of short-term gains. For example, an international company might invest in a domestic entity in a developing country. Rather than investing in greenfield direct investment, that entity uses the funds to buy short-term fixed income securities that can be easily liquidated. This type of transaction has been particularly problematic in countries such as China⁷ that have capital-account regulations that prohibit foreigners from investing directly in the short-term interest rate market. Nonetheless, they remain small relative to the total size of FDI flows in China, partly because China has adjusted its capital-account regulations to address the evasion.

South-South FDI flows have become increasingly important. Such flows proved particularly resilient during the global crisis of 2008-2009, in part because they were less dependent on debt financing. Companies from developing and transition economies, especially Brazil, China, India and the Russian Federation, have become increasingly important investors, with their share of global FDI rising from 15 per cent in 2007 to 28 per cent in 2010. This reflects the strength of their economies, the increasing dynamism of their corporations and their desire to acquire strategic resources abroad. Over 70 per cent of this investment is directed towards other developing and transition economies. South-South FDI is expected to increase in importance over the medium term in line with the growing strength of emerging economies and the growth of their transnational corporations.⁸ However, FDI flows to developing countries more generally are likely to be adversely affected in the event of a renewed slowdown in the global economy and, moreover, may be more volatile than in the past given the growing proportion of short-term and volatile flows contained within them.

While less volatile, FDI has become increasingly pro-cyclical

South-South FDI is becoming increasingly important

Portfolio flows and cross-border interbank loans

Similar to FDI, a large share of the increase in cross-border lending to developing countries has been directed towards the rapidly growing economies of the Asia-Pacific region, especially China and Latin America and the Caribbean, where Brazil has accounted for a large proportion of international bank loans.⁹ Moreover, there have also been concerns specific to regions, such as the Middle East and North Africa, owing to political turmoil, and Central and Eastern Europe, owing to the heavy reliance of a number of countries on loans from Western European financial institutions.¹⁰

International bank lending has recovered somewhat from its sharp decline in 2009, but is still only about 20 per cent of its pre-crisis level, as discussed in chapter I. The continuing financial difficulties facing the financial sector make bank lending vulnerable to any renewed downturn in the global economy, and it remains weighed down by continuing financial difficulties faced by banks in developed countries. In particular, a liquidity squeeze in European banks, as discussed below, is restricting lending from European institutions. The impact of this has been particularly acute in the transition economies in Europe and Asia and has served to restrain lending within these regions.¹¹

⁷ Yongding Yu, *The Management of Cross-Border Capital Flows and Macroeconomic Stability in China* (Penang, Malaysia: Third World Network, 2009); Shari Spiegel, "How to evade capital controls, and why they are still effective" in *Managing Capital Flows for Long-run Development* (Boston, Massachusetts: Boston University Pardee Center for the Study of the Longer Range Future, forthcoming).

⁸ UNCTAD, *Global Investment Trends Monitor*, No. 6 (27 April 2011).

⁹ IMF, *World Economic Outlook database*, op. cit.

¹⁰ World Bank, *Global Economic Prospects: Maintaining Progress amid Turmoil*, vol. 3 (Washington, D.C., June 2011).

¹¹ BIS, *BIS Quarterly Review* (Basel, Switzerland, June 2011).

Portfolio equity and bond flows to developing countries are also vulnerable to sharp shifts in sentiment. Corporate leverage appears to have increased in a number of emerging market countries in the earlier part of 2011, with weaker firms increasingly able to access capital markets. A point of concern is that the surge in capital flows into emerging corporate debt markets has been related to a mispricing of credit and a lack of due diligence on the part of investors, thereby increasing the vulnerability of emerging corporate debt markets to external shocks.¹² As global risk aversion increased, equity flows fell significantly in the third quarter of 2011. Although there was less of a sell-off in bond funds, investors chose to hedge the currency risk implicit in their holdings instead of selling the bonds, thus causing currencies around the world to weaken.

Carry trade and other derivatives

The carry trade is not fully reflected in the official balance-of-payment statistics

Most investors that wish to take advantage of high short-term interest rates in emerging market and developing countries do not actually buy short-term cash instruments, such as local currency treasury bills or local commercial paper. Instead, they transact through currency forwards, futures and options, in what is often called the carry trade.¹³ The size of carry trades in emerging market and developing country currencies at any one time is almost impossible to calculate, but estimates of the size of the market range from \$700 billion to as much as \$1.5 trillion,¹⁴ which would be significantly larger than other forms of capital inflows.

In 1993, the International Monetary Fund (IMF) recommended including these cross-border derivatives in the current account as a line item under the reporting category of “portfolio investment”. In 1998, it further recommended that member countries report such data as a separate reporting category labelled “financial derivatives”. Many countries have not done so, however. The United States of America, for example, began to include derivatives in balance-of-payments data only in 2007.¹⁵ In addition, cross-border derivatives contracts are difficult for regulators to monitor and are often not reported.

The balance of payments measures the amount of currency that flows across borders, so that the *net* value of derivative contracts is included in capital-account statistics. Although this measure might be appropriate from an accounting perspective, the net value is not a good measure of the risk associated with the transaction. In essence, the carry trade is a leveraged investment. An investor borrows in a currency with low interest rates, such as the United States dollar, and invests in a currency with higher rates, such as the Brazilian real, for a specified period. Thus, demand for the Brazilian real and Brazilian interest rates increases by the notional gross size of the contract. When the global appetite for risk changes and the carry trade unwinds, enormous pressure will mount on the local currency. Policymakers should thus monitor cross-border derivatives in conjunction with capital-account and balance-of-payment data. To do so, they need better surveillance of derivative products, as discussed below.

¹² See, IMF, *Global Financial Stability Report: Grappling with Crisis Legacies* (Washington, D.C., September 2011). The World Bank estimates that corporate borrowers have dominated bonds with about 80 per cent of year-to-date volume, with most issues coming from companies in China, Emerging Europe and Latin America (see World Bank, *Global Economic Prospects*, op. cit.).

¹³ In a typical forward carry trade, the investor agrees to buy a high yielding currency forward at a specified date and price, with the price determined by the relative interest rates between the two currencies.

¹⁴ Mike Dola, “Regulators tackle the ‘carry trade’”, *The New York Times*, 11 February 2010.

¹⁵ IMF, *IMF Balance of Payments Manual*, 5th ed. (Washington, D.C.); IMF, “Financial derivatives”, BOPCOM98/1/20, paper prepared for the Eleventh Meeting of the IMF Committee on Balance of Payments Statistics on 21-23 October 1998; Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, vol. 93 (Washington, D.C., 2007).

International reserves and the problem of the global imbalances

In response to risks associated with volatile inflows, many countries have used boom periods to build international reserves. This self-insurance strategy originated in the aftermath of a number of financial crises in emerging economies in the 1990s and served to protect those economies during the recent world financial and economic crisis, when a number of countries used reserves to moderate currency volatility, offset shortages in dollars faced by local markets and help create fiscal space. For example, in several East Asian economies reserve accumulation contributed to the policy space countries needed to allow them to put in place effective economic stimulus packages. While the tapping by a number of developing countries into their surplus reserves led to a fall in aggregate reserve holdings during the crisis, the recovery of exports and the subsequent return of capital flows facilitated renewed growth of reserve holdings.

Reserve holdings by emerging and developing countries are currently about \$7 trillion, a large proportion of which has been accumulated by developing countries in Asia, particularly China,¹⁶ as discussed in chapter I. However, the strategy of reserve accumulation can be sustainable only if there is at least one reserve-issuing country large enough and willing to run ever larger current-account deficits to ensure sufficient liquidity for global economic activity. These ever rising deficits can erode confidence in the reserve currency in that they eventually undermine its value, leading to a breakdown of the system. This dilemma emerges from the use of a national currency as the main international reserve currency and is one of the most important medium-term risks in generating global imbalances.

There are two main paths of reform that are being discussed by a variety of academics, analysts and policymakers. The first is to have multiple reserve currencies compete against each other. A multicurrency reserve system fails, however, to resolve the core deficiencies of the current system for a number of reasons. First, it would require national currencies, most of which would still be currencies of major industrial countries, to be used as reserve assets. A group of reserve currency countries would have to run increasing current-account deficits (or capital-account surpluses) to supply the world with reserve currencies. It would be particularly difficult for the European countries that are already restrained in monetary and fiscal policies to offset the contractionary impact of trade deficits arising from the supply of reserve currencies. Second, and more importantly, the diversification of reserve accumulation would then come at the cost of exchange-rate volatility among reserve currencies. Another reason for the undesirability of the multicurrency system is that it would not solve the inequity bias of the current system, since most developing countries would still be investing their savings into reserve assets issued by developed countries, and thereby transferring resources to them at very low interest rates. An alternative path is the design of a global currency, which can play the role of a reserve asset. One possibility is the use of Special Drawing Rights (SDRs) of the IMF.¹⁷

The Group of Twenty (G20) has encouraged discussion on reforming the international reserve system through reforms of the SDR mechanism (but not to the extent of using SDRs as a reserve currency). There are several reasons for resuming the allocations

Emerging and developing countries hold about \$7 trillion in reserves

Self-insurance through building reserves has exacerbated global imbalances

¹⁶ IMF, World Economic Outlook database, op. cit., table A15.

¹⁷ See Bilge Erten, "Allocation of SDRs for development purposes", background paper for *World Economic and Social Survey 2012* (United Nations publication, forthcoming).

of SDRs. SDRs can be used as an instrument to fund IMF emergency financing during crises, as discussed below. Sustained SDR allocations could also provide a low-cost alternative to accumulation of international reserves, and could reduce the need for precautionary reserve accumulation by providing access to foreign currency liquidity. In other words, greater use of SDRs could reduce the need for self-insurance by many developing countries. Second, regular SDR allocations are a potential source of finance since seigniorage related to additional demand for global currencies accrues to IMF member States. Under the current quota distribution, more than half of the newly allocated SDRs will accrue to developed countries. Nonetheless, countries with excess allocations can lend SDRs to countries in need, thereby leveraging existing SDR allocations. Countries can then exchange the SDRs for tradable currencies to meet balance-of-payment obligations.

However, the use of SDRs as direct development finance is somewhat problematic since fiscal use of allocated SDRs by developing countries is illegal under the current IMF Articles of Agreement and would require a substantial amendment of these Articles. One suggestion to address this limitation is for the IMF to use newly allocated SDRs to buy bonds issued by multilateral banks, which could in turn use the funds to finance development projects.¹⁸ Other solutions envision employing unused SDRs to finance global public goods, such as through a green fund.

Net financial transfers

Developing countries transferred \$827 billion in financial resources to developed countries in 2011

The vast majority of global reserves have been invested in low-yielding United States Treasuries and other sovereign paper, with the effect of transferring financial resources from the developing to the developed world. Developing countries, as a group, are expected to have transferred a net amount of financial resources¹⁹ of approximately \$826.6 billion to developed countries in 2011 (see figure III.1A and table III.2).

The largest net outward transfers are in East and South Asia, reflecting trade surpluses and high levels of reserve accumulations. Africa and West Asia experienced strong increases in net outward resource transfers in the first half of 2011, reflecting continued growth in export revenues of net fuel exporters in both regions, owing to the continued surge in oil prices. Net outward transfers of countries in Latin America and Caribbean remained at high levels in line with a relatively stable regional trade performance and increased reserve accumulation in some countries, such as Brazil. Sub-Saharan Africa was the only region not to have net outward transfers.

As shown in figure III.1B, most of the net transfers from developing to developed countries were from upper middle income countries. Net outflows from upper middle income countries increased by \$85 billion in 2011, to \$580 billion, reflecting the continued reserve accumulation in these countries. Net outflows from lower middle income countries increased to \$40 billion in 2011, nearly doubling 2010 levels. However, lower middle income countries receive net inflows of \$36 billion, representing a slight increase in inflows from 2010. Thus, in 2011, the pre-crisis pattern returned; upper middle

¹⁸ José Antonio Ocampo, "Reforming the international monetary system", lecture delivered at the 14th WIDER Annual Lecture held at the United Nations in New York, 9 December 2010. Available from http://www.wider.unu.edu/publications/annual-lectures/en_GB/AL14/.

¹⁹ The net transfer of financial resources measures the total receipts of net capital inflows from abroad minus total income payments (or outflows), including increases in foreign reserves and foreign investment income payments. Therefore, when reserves are greater than net capital inflows, there is a net outflow of financial resources.

Figure III.1A
**Net transfers of financial resources to developing economies
 and economies in transition, 1999-2011**

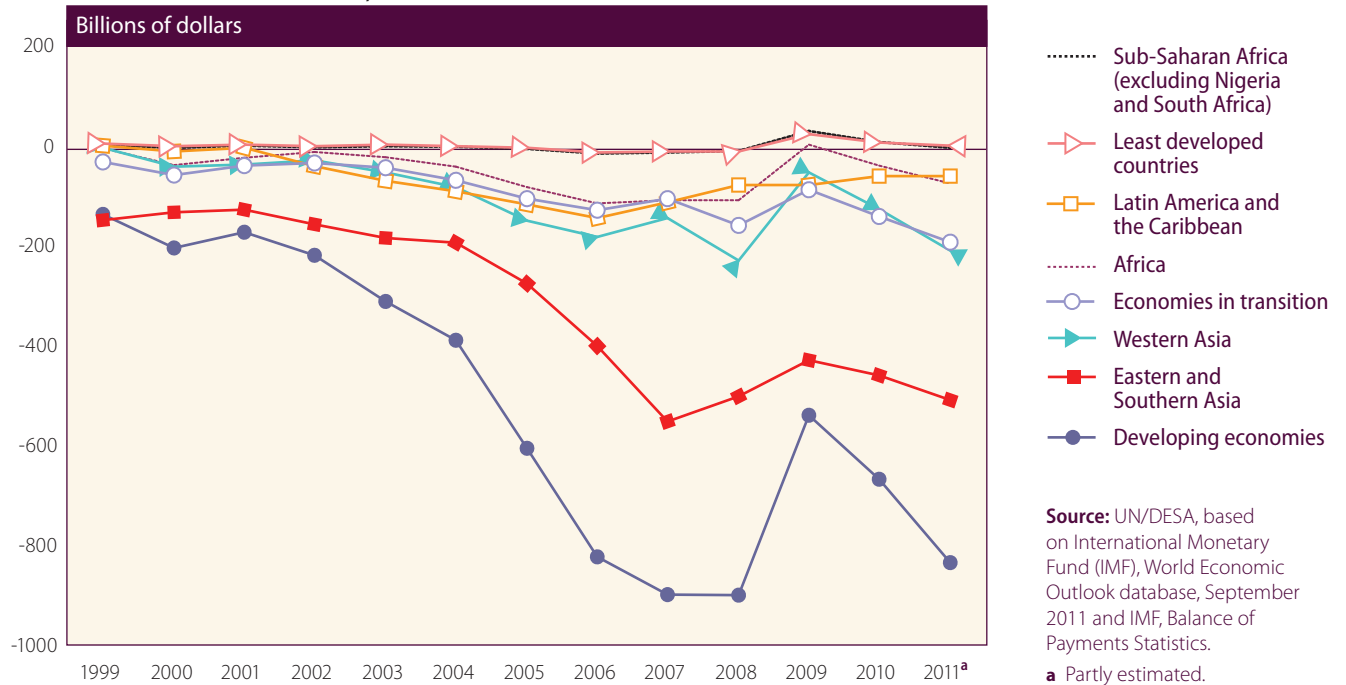


Figure III.1B
Net financial transfers, by income category, 2001-2011

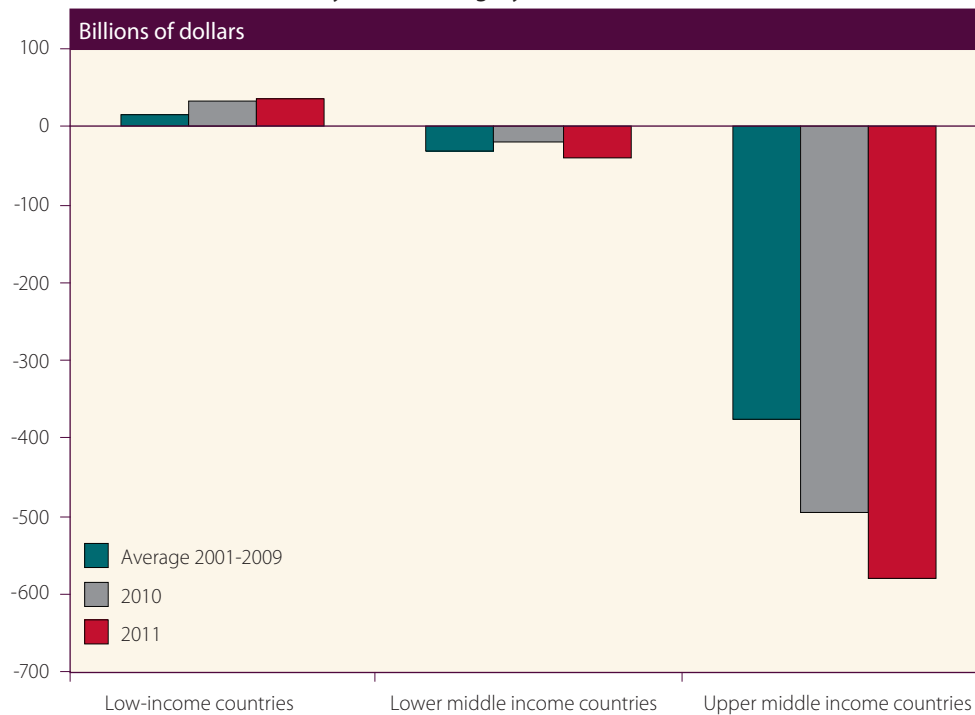


Table III.2
Net transfers of financial resources to developing economies and economies in transition, 1999-2011

Billions of dollars													
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 ^b
Developing economies	-130.3	-197.5	-165.8	-212.6	-304.3	-382.0	-598.8	-815.4	-890.9	-891.6	-531.9	-659.8	-826.6
Africa	1.2	-31.9	-16.8	-5.9	-16.5	-34.8	-76.1	-108.5	-102.5	-101.8	8.8	-33.1	-68.3
Sub-Saharan Africa (excluding Nigeria and South Africa)	8.2	2.8	6.8	3.6	6.0	4.4	0.6	-8.6	-7.1	-3.3	36.5	14.7	2.9
East and South Asia	-141.5	-126.0	-121.0	-150.6	-178.0	-186.9	-268.7	-393.9	-544.8	-494.7	-422.5	-452.8	-501.5
Western Asia	2.7	-35.3	-30.6	-22.5	-46.2	-76.0	-143.1	-175.6	-137.3	-223.0	-46.1	-120.0	-203.0
Latin America and the Caribbean	7.3	-4.3	2.5	-33.7	-63.5	-84.3	-110.9	-137.4	-106.4	-72.1	-72.1	-53.9	-53.8
Economies in transition	-25.1	-51.6	-32.9	-27.6	-37.5	-62.0	-99.3	-122.3	-99.4	-152.3	-81.3	-135.0	-186.5
Least developed countries ^a	11.4	6.4	9.3	6.2	8.9	6.2	2.5	-6.4	-4.5	-4.4	30.4	13.2	7.4

Sources: UN/DESA, based on International Monetary Fund (IMF), World Economic Outlook database, September 2011 and IMF, Balance of Payments Statistics.

^a Cape Verde graduated in December 2007; hence excluded from the calculations.

^b Partly estimated.

income countries transferred significant resources to richer nations while continuing with the accumulation of foreign-exchange reserves as self-protection against new global economic shocks, while poorer countries continued to have positive net transfers, albeit at a low level compared to total global flows.

The continued high volatility in portfolio flows will likely increase the perceived need for self-protection during 2012. Nonetheless, many middle-income countries have already accumulated large international reserves, and additional accumulation of reserves can be costly. As discussed above, there is an opportunity cost associated with buying United States Treasuries as opposed to investing in domestic development. In addition, to buy reserves, central banks intervene in the domestic foreign exchange market, buying dollars or other currencies and selling the domestic currency. This has the effect of increasing the domestic money supply, which can be inflationary. In response, central banks often sterilize the inflows through open market or similar operations. This results in greater demand for local securities, which drives up interest rates. Ironically, the higher interest rates can then attract even greater amounts of short-term capital flows, in a continuing cycle. In response, policymakers have been implementing or considering implementing capital-account regulations to moderate high volatility in capital inflows.

Capital-account management

Capital controls can help mitigate the impact of volatile financial flows

Capital-account management has recently gained greater acceptance as a prudent policy measure by the international community. The IMF, which recommended against the use of capital controls in the 1990s (even though it was in contravention of Article VI of the IMF Articles of Agreement, which recognizes the sovereign right of member States to control their capital accounts), has acknowledged that capital flow management can help reduce the volatility associated with international flows under certain conditions. Indeed, over the past few years, several countries, including Brazil, Indonesia and Thailand, have introduced measures to contain the surge in short-term capital flows, as shown in table III.3.

Table III.3
Selected capital account regulations taken by developing countries (since 2009)

<i>Instrument</i>	<i>Country</i>	<i>Policy Measure</i>	<i>Effective Date</i>
Tax measures and fees	Republic of Korea	Reintroduced a 14 per cent withholding tax on interest income and 20 per cent capital gains tax on Korean government bonds (KTBs) and monetary stabilization bonds (MSBs).	January 2011
		Imposed a macroprudential levy of up to 0.5 per cent on banks' non-deposit foreign currency liabilities.	August 2011
	Thailand	Removed a 15 per cent tax exemption for foreigners on capital gains and interest payments earned from investing in domestic bonds.	October 2010
	Brazil	Raised tax on fixed-income foreign investment to 6 per cent (introduced in October 2009 at 2 per cent).	October 2010
		Introduced a 1 per cent tax on derivatives transactions which result in an increase in short currency (dollar) exposure or a reduction in long currency (dollar) exposure.	October 2011
	Peru	Increased fee on non-resident purchases of central bank certificates of deposit (CDs) from 10 basis points to 400 basis points.	August 2010
Quantitative limits	Republic of Korea	Instituted a cap on banks' holdings of foreign exchange derivative contracts (250 per cent of equity capital for foreign bank branches and 50 per cent for domestic banks).	June 2010
		Reduced the limit on currency forward transactions from 125 per cent to 100 per cent of the real transactions being hedged.	June 2010
		Instituted a cap on derivative positions (in response to an options sell-off on 11 Nov 2010), limiting the number of speculative options and futures contracts an institutional investor can hold to a maximum of 10,000 per day (Previously, institutions could hold 7,500 futures, with no limit on options contracts).	January 2011
	Indonesia	Reintroduced a 30 per cent cap on lenders' short-term overseas borrowing.	January 2011
	Taiwan Province of China	Introduced a ban on foreign investors' placing funds into time deposits.	November 2009
		Reactivated regulation that caps foreign investment in Taiwan government bonds and money market products at 30 per cent of investors' total portfolio. (Previously, the 30 per cent cap had only applied to debt maturing in less than one year).	November 2010
Minimum investment periods	Indonesia	Imposed a minimum one-month holding period for Bank Indonesia Certificates (SBIs).	July 2010
Reserve requirements	Indonesia	Raised the reserve requirement ratio for foreign currency deposits from 1 per cent to 5 per cent (proposed to increase to 8 per cent in June 2011).	March 2011
	Brazil	Introduced requirement for local banks to deposit 60 per cent of their short positions in US dollars, interest-free, at the Central Bank after deducting 3 billion dollars or their capital base, whichever is smaller.	April 2011
	Peru	Increased the marginal reserve requirements for short-term domestic currency deposits to 120 per cent (from 65 per cent)	September 2011

Sources: Institute of International Finance (IIF), "Capital flows to emerging market economies", IIF Research Note, 24 January 2011; IMF, "Recent experiences in managing capital inflows—cross-cutting themes and possible policy framework", 14 February 2011; national central banks and other agencies.

Countries have a range of policy instruments at their disposal to manage cross-border capital flows. Three categories of responses are usually distinguished: macroeconomic policies, macroprudential measures and other forms of capital-account management, including capital flow regulations. Capital-account regulations should be an essential part of a broader counter-cyclical macroprudential risk management of the domestic financial sector, and should not be viewed any differently than regulation of domestic risks. Such regulations—which include price and quantity regulations, including taxes, reserve requirements, minimum investment periods and quantitative limits on certain types of cross-border capital transactions—directly target capital flows, whereas macro-tools focus on overall economic variables and the domestic regulatory framework.

The IMF position has been that capital-account regulations should be employed only when macroeconomic and prudential policy measures are not sufficient to counter the negative impact of capital inflows. However, the textbook response of dealing with capital inflows by letting foreign exchange rates appreciate and slashing fiscal spending is often inadequate and can have negative side effects. Letting the exchange rate strengthen can penalize export-oriented sectors, thus impacting growth and development, while fiscal cuts can be costly, and the slow speed of fiscal decision-making makes it an ineffective policy tool for dealing with short-term volatile capital inflows. Furthermore, adopting regulations at an early stage could help limit capital inflows before asset bubbles and other risks to the economy materialize. Instead, policy measures should target the source of shocks from the outset, and therefore aim at reducing the volatility of capital flows.

The IMF also contends that countries should let their currencies appreciate to fair valuation before capital controls are enforced, in order to avoid beggar-thy-neighbour policies. However, policymakers from developing countries are wary of this rule as it could impede domestic policy space. This is particularly the case since it is extremely difficult to gauge when a currency is fairly valued; in fact, one of the reasons that capital-account regulations are necessary is because the market is not fairly valuing currencies. In addition, economic costs associated with boom and bust cycles, including increased volatility of the exchange rate and potential bubbles in sectors of the economy, exist whether or not a currency is considered over- or undervalued from a theoretical perspective.

Although many economists argue that capital controls should be temporary, there is a case to be made for permanent regimes, especially given the medium-term cycles in capital flows discussed above. Since capital flows can change rapidly, policymakers may need to be able to react swiftly, which is easier in a permanent regime of capital-account regulation. Such a permanent regime could be adjusted to the country's circumstances. In this way, policies could be re-enacted quickly in a counter-cyclical fashion, and market actors would not be caught off-guard if capital-account regulations have to be reintroduced.

Despite renewed interest in capital-account regulations, their effectiveness remains under debate. Most available studies find that capital controls have been effective in changing the composition of inflows away from short-term debt in many cases.²⁰ However, the impact on total flows is more ambiguous, with regulations appearing to have been more successful in some cases than in others. This implies that the design of regulations is crucial to their success. No one-size fits all for the effectiveness of the alternative tools, and

As capital flows exhibit medium-term volatility, permanent regimes of management may be preferable

²⁰ See, for example, Jonathan D. Ostry and others, "Capital inflows: the role of controls", IMF Staff Position Note, SPN10/04 (Washington, D.C., February 2010).

a thorough analysis of the unique situation of each country needs to guide the decision-making over which tools to use. Countries that have a high level of dollarization, such as Peru, might choose to focus on prudential regulations in the banking system to minimize currency mismatches, while countries with large domestic local currency markets, such as Brazil, might choose to implement direct regulations, such as taxes on inflows.

As shown in table III.3, Brazil has initiated a 6 per cent tax on inflows. In addition, Brazil has also initiated new measures on cross-border derivatives which seek to limit speculative positions in the foreign exchange market via a tax on unhedged bets. For this regulation to work, Brazil needs reliable information, which they ensure by making the legal enforceability of derivatives contracts depend upon their registration in clearing houses. As such, Brazilian authorities believe that the imposition of the tax will help them keep better track of derivative positions. Brazil introduced this tax at a low level of 2 per cent, although it reserves the right to increase the tax to up to 25 per cent.

Nonetheless, despite these measures, the Brazilian real devalued by 16 per cent during the increased global risk aversion of the third quarter of 2011, as discussed in chapter I. Although policymakers might welcome the weaker currency, the implication is that the earlier capital-account regulations were not fully effective in reducing volatility. However, the regulations on derivatives affected only new transactions and were only introduced in August, when sizable positions were already built in the local markets. In addition, policymakers in Brazil acknowledge that a 2 per cent tax is likely not sufficient to reduce inflows when local yields are still above 10 per cent.

Brazil's tax on inflows is a form of price control. Many economic analysts tend to prefer such price controls over quantity controls, such as China's or India's ban on short-term flows. They do so in the belief that price controls are less opaque and more flexible, a factor considered particularly important in sophisticated markets. In practice, however, it is difficult to calculate the optimal tax for a price-based mechanism, especially when information asymmetries exist. Because information asymmetries are particularly acute in the financial sector, the IMF suggests a rule of thumb with price-based measures preferable in general, and quantity-based measures more appropriate for prudential purposes.²¹ However, when interest rate differentials are large and/or the market expects strong currency appreciation, the tax or other price-based mechanism might have to be so high to be effective as to render its implementation politically infeasible or impractical. Quantity restrictions could be preferable in such cases.

In an era of financial globalization, it is no longer possible for any individual country to fully manage cross-border risk by unilateral action. Multilateral cooperation on capital-account regulations could be an important element of the international financial system. In particular, there is some fear that the implementation of measures to manage capital flows in one country might divert more speculative flows to other countries. However, developing countries have argued that evidence of negative spillover effects is limited, and that multilateral coordination of capital-account regulations and rules would serve only to reduce countries' policy space. Bilateral and regional coordination might be an alternative to global rules. In addition, coordination would optimally include policy actions in the source countries to help reduce flows from the outset. To do so, however, would require reforms of the international financial architecture and domestic regulations.

²¹ Jonathan D. Ostry and others, "Managing capital inflows: what tools to use", op. cit.

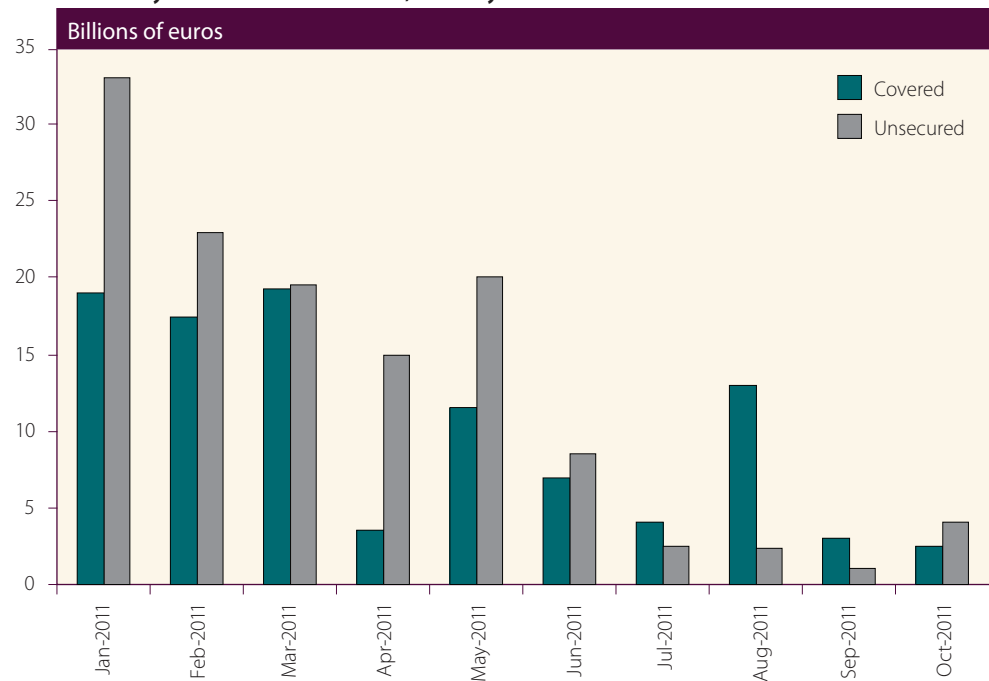
International financial reform

New reforms of the financial systems are being phased in gradually

The international community has continued its efforts to reform and strengthen the international financial system. These include the introduction of Basel III, and the United States Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as discussions on regulations for systemically important institutions. However, most of these measures are being phased in over a prolonged period of time and, as such, have not had an impact on the current economic and financial situation, including the risks in the European banking sector.

The extent of credit risk and insolvency in the European banking system owing to the European sovereign debt crisis is unclear. Several studies have estimated that the impact is uneven across the banking sector. A recent IMF analysis found that only a small number of banks are in the high-risk zone, representing 1 per cent of assets, while a greater proportion (22 per cent of banks representing 12 per cent of assets) fall into the second-highest risk zone.²² Nonetheless, the banks that are stronger appear to have been hoarding cash, which has led to a liquidity squeeze in the interbank market. For example, most of the €56 billion supplemental long-term refinancing operations (SLTRO) provided on 26 October 2011 were placed back into the deposit facility, which implies that banks with surpluses are holding cash rather than lending it on the interbank market.²³ Figure III.2 shows how bank wholesale term funding has collapsed. The fact that issuance of covered bonds, which have limited credit exposure, has also dropped significantly is a sign that the drop in funding is the result of a liquidity crisis rather than of solvency issues.

Figure III.2
European bank wholesale term funding, debt securities issued by bank sector borrowers, January–October 2011



Sources: Daniel Davies and Jag Yogarajah, "Liquidity—when it comes to the crunch", (Paris, France: Exane BNP Paribas, 7 November 2011); Dealogic.

²² IMF, "Global Financial Stability Report", op. cit.

²³ Daniel Davies and Jag Yogarajah, "Liquidity—when it comes to the crunch", (Paris, France: Exane BNP Paribas, 7 November 2011).

As discussed above, banks facing funding pressures often limit intragroup financing of foreign branches to preserve liquidity, thereby impacting financing for emerging and other developing countries. This is particularly problematic for developing countries with large foreign banks, as we saw during the financial crisis. The current strain of the liquidity squeeze in Europe will likely have a particularly strong impact on Eastern European countries.

More broadly, risks to the international financial system threaten financing for developing countries, increasing the perceived need for countries to self-insure. Steps to reduce risks in financial systems in industrialized countries should thus have positive spillovers on global risk and development. In addition, these new regulations have implications for the design of developing countries' domestic financial regulations.

Progress in reforming international financial regulation²⁴

The Basel III standard on bank capital and liquidity

A major step in the reform process has been the introduction of the Basel III framework for bank capital and liquidity regulation. The Basel Committee on Banking Supervision issued the Basel III rules text on 16 December 2010, following the endorsement by the G20 leaders at their November 2010 summit. It now needs to be transposed into national law and applied according to the agreed schedule. The Basel III requirements will be phased in gradually starting from January 2013 and are to be fully implemented by January 2019.

Basel III is intended to cure several shortcomings revealed by the crisis. It provides for higher minimum capital requirements (doubling core capital), improved quality of capital and larger liquidity buffers. In addition, a simple leverage measure of 1 to 30 is introduced as a capital conservation buffer. Along with the traditional microprudential approaches, which focus on the risk of individual banks, Basel III also attempts to strengthen the macroprudential policy framework. Macroprudential policies aim to address a system-wide risk by dampening financial system pro-cyclicality and reducing systemic risk concentrations. One macroprudential tool introduced by Basel III is a separate counter-cyclical capital buffer. This buffer will be determined by the relevant regulator in each jurisdiction according to its perception of the systemic risk that has built up in the banking system as a result of excess credit growth, and will range from between 0.0 and 2.5 per cent of a bank's risk-weighted assets, to be held in common equity.

These changes are meant to increase the capacity of banks to better withstand future shocks. However, several recent studies have suggested that the changes are likely too small to increase the resilience of the system sufficiently. They suggest that core capital should be 25 per cent of risk-weighted assets.²⁵ A recent study by the Bank of England, using fifty years of data, suggests even stronger requirements; it finds that 50 per cent of risk-weighted assets is an appropriate level of capital adequacy, given the historical frequency and severity of crises.²⁶ Both of these amounts are significantly greater than what

Basel III is a major step in the reform process

Basel III does not adequately address present global risks

²⁴ For a more detailed discussion and critique of these measures and policy implications for emerging market countries, see Stephany Griffith-Jones, Shari Spiegel and Matthias Thiemann, "Recent developments in regulation in light of the global financial crisis: implications for developing countries", background paper for the UN/DESA-sponsored conference on "Managing the capital account and regulating the financial sector: a developing country perspective", held in Rio de Janeiro, Brazil, on 23-24 August 2011. Available from http://www.un.org/en/development/desa/policy/capacity/capital_account/.

²⁵ Ibid.

²⁶ David Miles, Jing Yang and Gilberto Marcheggiano, "Optimal bank capital". External MPC Unit Discussion Paper, No. 31 (London: Bank of England, April 2011).

is currently envisaged by Basel III. Critics have also pointed out that a leverage ratio of 1 to 30 would not have posed significant problems for most banks before the crisis.

The Basel III liquidity standards require banks to have sufficient high quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. One of the important innovations is to include off-balance-sheet obligations of the banks. However, the extent to which these measures will increase the resilience of the financial system cannot yet be gauged, because they will come into force only in 2018. In the meantime, the liquidity coverage ratio has successfully been applied in the Netherlands, where it has been in force since 2003. Most Dutch banks remained liquid throughout the crisis and avoided failure, even though many of the banks had high off-balance-sheet obligations. It is unclear whether the strengthened regulatory framework of Basel III would have been sufficient to prevent the current liquidity crunch in Europe. To the extent that there is always a risk of a bank run, in either the wholesale market or the deposit market, the role of a lender of last resort is necessary to limit liquidity squeezes. This is somewhat complicated in Europe where the European Central Bank (ECB) is exclusively tasked with guarding inflation and is not supposed to maintain the health of the banking system, and individual country central banks cannot print money.

One goal of Basel III is to create a globally consistent and harmonized regulatory structure as a way to ensure a level playing field. It is thus considered important to discourage a competitive race to the bottom and beggar-thy-neighbour policies that might benefit narrow national interests at the expense of global financial stability. At the same time, given diverse national structures, the challenge is to strike the right balance between ensuring an international level playing field and accommodating country differences, in order not to place an unnecessary burden of adjustment on national financial systems. Repercussions of Basel III on access to financing for low-income countries should also be taken into account, including possible adverse impacts on trade finance, since Basel rules do not give credit to the collateral used to secure trade financing. Similarly, applying Basel III to developing country banks could result in reduced domestic long-term lending. This may be counteracted, however, through changes in domestic regulatory systems in developing countries, as discussed below.

Regulation of systemically important financial institutions and the shadow banking system

The 2008-2009 global financial crisis underscored the need to put in place additional measures to reduce the likelihood and the severity of problems emerging at systemically important financial institutions. Accordingly, in addition to the Basel III standards, an international effort is under way to reduce the probability of failure for such institutions or, in the event of a failure still occurring, to limit its impact on the financial system as a whole.

The Financial Stability Board (FSB) has developed a set of policy measures to address systemically important financial institutions (SIFIs), particularly globally systemically important financial institutions (G-SIFIs).²⁷ The implementation of the set of policy measures and the timeline for their implementation were endorsed by the G20 leaders at their Cannes Summit in early November 2011.

The Financial Stability Board has developed a framework to address globally systemically important financial institutions

²⁷ Financial Stability Board (FSB), "Policy measures to address systemically important financial institutions" (Basel, Switzerland, 4 November 2011), available from http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

A key element of the measures is that SIFIs should have a loss-absorbing capacity beyond the general Basel III, including an additional 1.0-2.5 per cent capital versus risk-weighted assets, to be held in common equity, depending on a bank's systemic importance. For banks facing the highest surcharge, an additional loss absorbency of 1 per cent could be applied. The additional capital charges are also thought to level the playing field by reducing too-big-to-fail competitive advantages in funding markets. The FSB and the Basel Committee on Banking Supervision have identified an initial group of 29 G-SIFIs, which will be updated annually based on criteria such as size, interconnectedness and substitutability. However, the additional 1.0-3.5 per cent is still significantly below what many studies have determined as sufficient levels of capital. Nonetheless, the attention to the issue and the additional requirements constitute important steps in reducing the risks associated with being "too big to fail".

The measures put forth by the FSB further aim to establish more intensive and effective supervision of all SIFIs. Moreover, the FSB defined key features and instruments that all national resolution regimes should have to enable authorities to resolve failing financial firms in an orderly manner and to determine requirements for resolvability assessments and for recovery and resolution planning for G-SIFIs. The implementation of these measures will begin in 2012, with full implementation targeted for 2019, a relatively long phase-in period, which opens up the risk that rules will not be implemented consistently across countries.

The FSB intends to complement these policy measures with stronger international standards for core financial market infrastructures to reduce contagion risks when failures occur. Another important issue is integrating into the regulatory framework the so-called shadow banking system, for instance, credit intermediation through non-bank channels. In this context, there is a need to ensure that tighter regulatory rules on banks do not provide incentives for financial institutions to shift their activities to unregulated areas. The challenge is to establish an appropriate definition of shadow banking and outline possible regulatory measures to address the risks posed by this sector. In October 2011, the FSB set out principles for the monitoring of shadow banking,²⁸ which calls on the relevant authorities to first assess the broad scale and trends of non-bank credit intermediation in the financial system. Based on this assessment, authorities should narrow their focus to those types of non-bank credit intermediation that have the potential to pose systemic risks, by focusing in particular on those involving key risk factors, such as maturity transformation, liquidity transformation, imperfect credit risk transfer and/or leverage. Authorities should then assess the potential impact of the severe distress or failure of certain shadow banking entities on the overall financial system.

In addition, the FSB defined five specific areas for which recommendations for further regulatory action will be developed in 2012: banks' interactions with shadow banking entities, money market funds, other shadow banking entities, securitization and securities lending and repurchase agreements. In addition to the key areas outlined, the FSB is studying other regulatory initiatives, including regulations for over-the-counter derivatives, rating agencies, alternative investment vehicles, consumer finance protection and financial market infrastructures.

The FSB is also developing a regulatory framework for the shadow banking system

²⁸ FSB, "Shadow banking: strengthening oversight and regulation" (Basel, Switzerland, 27 October 2011), available from http://www.financialstabilityboard.org/publications/r_111027a.pdf.

Financial stability and regulation in emerging economies and developing countries

Developing countries can draw lessons from international financial reforms

There are several lessons that policymakers in developing and emerging markets can draw from these reforms for the design of domestic regulations. As Basel III was designed for sophisticated financial markets, it is not clear that all of the measures in the agreement are appropriate for developing countries. In particular, reforms to banking regulation also need to take into account any impact they may have on growth and access to credit, as well as on stability.

Policymakers in developing countries can choose to implement the elements of these agreements that best suit their needs. For example, it might make sense for policymakers to integrate several of the ideas underlying Basel III—such as counter-cyclical buffers, liquidity ratios, increase in the quantity and, especially, the quality of core capital, adapted to local circumstances—into national regulatory frameworks. A case may even be made for countries to accelerate the implementation of Basel III suggestions onto a schedule that is quicker than the gradual one of Basel itself in areas that would be particularly relevant to their financial systems (such as, for example, counter-cyclical regulation). Policymakers should also engage in emergency planning to address the failure of large international banks operating in the country. Requiring banks to have subsidiaries, rather than branches, in the local market can help in this area. Alternative measures such as public development banks and directed credit could also be employed to improve access to credit.

More broadly, reforming and improving financial regulation in emerging economies and developing countries is an important part of the global reform agenda to promote the mobilization of resources, reduce risks and promote financing for development.

Global liquidity mechanisms: current debates and the need for further reform

Countries rely on a hybrid mechanism to cope with systemic crises

An effective global financial safety net is an important backstop for the preservation of global economic and financial stability. Currently, countries rely on a hybrid system of financial safety, combining reserve accumulation, bilateral agreements and regional and multilateral mechanisms to cope with systemic crises.

The international financial safety net was strengthened during the recent crisis and its aftermath. In 2010, the IMF increased the duration and credit available under the existing Flexible Credit Line, an insurance option for countries with very strong policies and economic fundamentals, and established a new Precautionary Credit Line. The Precautionary Credit Line, a form of contingency protection, is designed for those countries that do not qualify for the Flexible Credit Line, but that have only moderate vulnerabilities. Unlike the Flexible Credit Line, the Precautionary Credit Line features ex post conditionalities focused on reducing any remaining vulnerabilities identified in the qualification assessment. G20 leaders, at their summit in November 2011, expressed support for the IMF in putting forth a new Precautionary and Liquidity Line (PLL) to provide, on a case-by-case basis, increased and more flexible short-term liquidity to countries with strong policies and fundamentals facing exogenous shocks.

Resources available to the IMF to carry out its lending activities have increased significantly. The Fourteenth General Review of Quotas was completed in

December 2010, with a decision to double IMF quota resources to approximately \$750 billion, and is awaiting ratification by the membership. Borrowing arrangements with member countries and central banks have also been enhanced. The expanded and more flexible New Arrangements to Borrow, with a total borrowing capacity of about \$580 billion, became operational in 2011. However, discussions to further enhance IMF resources have stalled.

In order to ensure the capacity of the IMF to provide large-scale liquidity support in the future, there are proposals to further enlarge its resource base, such as by issuing SDRs, as discussed earlier. The G20 is considering enhancing the SDR basket to include additional currencies and potentially increasing allocations of SDRs. The current requirement for inclusion in the basket, as set out in the IMF Articles, is that a currency be “freely usable”, implying widely used and widely traded. This requirement was implemented only in 2000, and discussions are currently under way for including alternative criteria, tailored explicitly to the reserve asset characteristics of the SDR, to be based on three key characteristics: liquidity in foreign exchange markets; “hedgeability”; and availability of appropriate interest rate instruments. However, this view has been challenged by some developing countries, which point out that the basket has included non-tradable currencies that did not meet these criteria in the past.

While the cooperative efforts during the crisis have strengthened the global financial safety net, important issues remain regarding the sufficiency and composition of international liquidity support. Indeed, the crisis has highlighted the need for large liquidity buffers to deal with fast and sizeable capital market swings. This requires a further strengthening of the multilateral capacity to cope with shocks of a systemic nature. In this regard, it has been stressed that in the recent crisis, the bulk of the needed liquidity was provided through ad hoc arrangements deployed on a one-off basis by key central banks. It has also become evident that uncertainties about the availability and functioning of financial safety nets can impose significant costs.²⁹

There are a number of suggestions on how to make the global financial safety net more effective and predictable. An ambitious proposal is to develop the IMF as an international lender of last resort that would provide access to liquidity when no other lender is willing to lend in sufficient volume to deal effectively with a financial crisis.³⁰ Countries could qualify for access to this facility through regular Article IV IMF surveillance without additional conditions. The liquidity would need to be largely provided by countries issuing reserve currencies, which would, however, impose far-reaching obligations on major central banks to grant access to liquidity when the facility is triggered. The IMF itself is exploring related options to set up a permanent mechanism to provide liquidity in systemic crises in conjunction with bilateral and regional liquidity support arrangements.³¹

A key element in strengthening the global financial safety net is closer cooperation with regional and subregional mechanisms. Regional financial arrangements can play an important role in preventing and mitigating financial crises and strengthening the global

SDR issuance could be used to strengthen the global financial safety net

Greater coordination is needed between multilateral and regional financial safety net mechanisms

²⁹ See, “Assessing the agenda for economic policy cooperation”, speech by John Lipsky, IMF First Deputy Managing Director, at the Conference on Macro and Growth Policies in the Wake of the Crisis, Washington, D.C., 7 March 2011, available from www.imf.org.

³⁰ See, for instance, Eduardo Fernández-Arias and Eduardo Levy-Yeyati, “Global financial safety nets: where do we go from here?”, IDB Working Paper Series, No. IDB-WP-231 (Washington, D.C.: Inter-American Development Bank, November 2010).

³¹ IMF, “The Fund’s mandate—the future financing role: reform proposals”, Washington, D.C., 29 June 2010, available from www.imf.org.

financial safety net. Major regional arrangements are the Arab Monetary Fund (AMF), the Chiang-Mai Initiative (CMI), assistance facilities within the European Union (EU) and the Latin American Reserve Fund (FLAR). Positive experiences with regard to regional balance-of-payments assistance facilities exist particularly in Latin America. The FLAR is the issuer with the highest rating in Latin America and has been contributing to regional financial stability by providing member countries with crisis liquidity. In other regions, reserve funds and financial assistance facilities are currently being enhanced. In Europe, the European Financial Stability Facility was created in 2010 as a vehicle to fund assistance to member countries in financial distress; it is to be succeeded by the permanent European Stability Mechanism (ESM) in 2013. In Asia, the Association of Southeast Asian Nations (ASEAN)+3 countries³² in 2010 enhanced the Chiang-Mai Initiative from a bilateral swap network to a multilateral reserve pool arrangement so as to strengthen the region's capacity to address balance-of-payments and short-term liquidity difficulties. Member countries also introduced a voting procedure for the disbursement of funds. Most of these mechanisms have provided crisis liquidity to member States during the recent economic and financial crisis, partly in conjunction with IMF programmes.

International development cooperation and official flows

Official development assistance

ODA peaked at \$128.7 billion in 2010...

Official development assistance (ODA) from member countries of the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD) reached a record level of \$128.7 billion as at the end of 2010 (see figure III.3). This accounts for 0.32 per cent of DAC members' combined gross national income (GNI). The largest increases in real terms in ODA between 2009 and 2010 were recorded by Australia, Belgium, Canada, Japan, the Republic of Korea, Portugal and the United Kingdom of Great Britain and Northern Ireland.³³

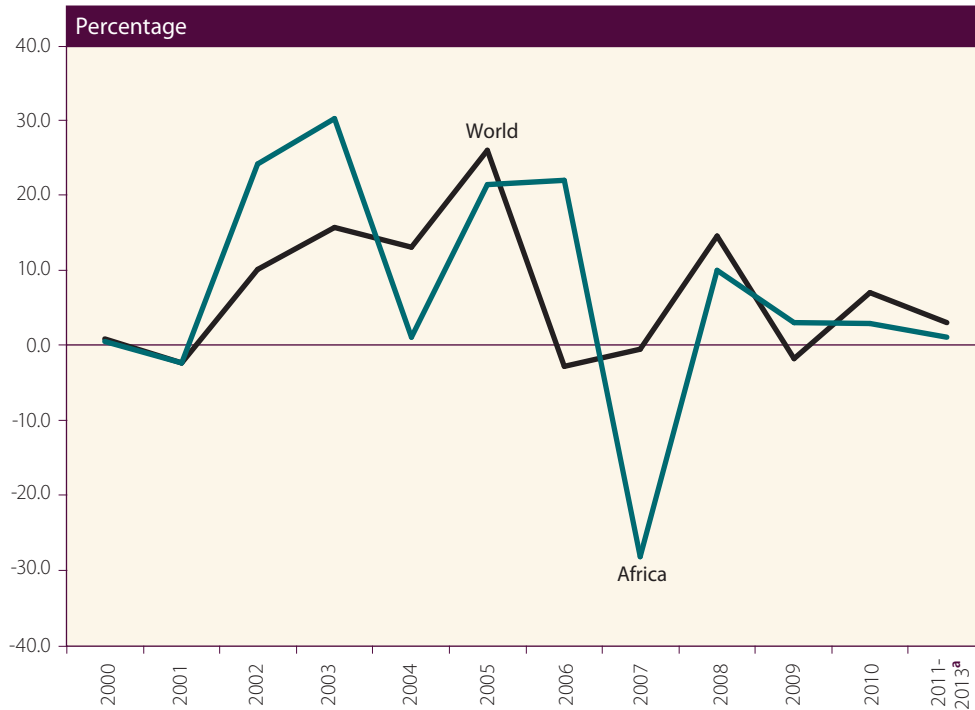
...but fell well short of commitments

However, aid flows remain insufficient and aid delivery has been pro-cyclical and volatile. Global aid delivery remains far below the United Nations target of 0.7 per cent measured as the ratio of net ODA to donor country GNI. Only five countries (Denmark, Luxembourg, the Netherlands, Norway and Sweden) have met or exceeded that target. For DAC donors as a whole, however, aid flows fell \$18 billion short of the \$127 billion (in 2004 prices and exchange rates) pledged for 2010 at the 2005 Gleneagles Group of Eight (G8) Summit. The shortfall in aid to Africa is an even larger percentage. At Gleneagles, donors pledged to increase ODA to Africa by \$25 billion per year, yet Africa had only received an additional \$11 billion on an annual basis by the end of 2010. DAC member countries' ODA to the least developed countries (LDCs) rose from 0.05 per cent (or \$12 billion) of their aggregate GNI to 0.10 per cent (or \$37 billion). Again, this level of ODA is still well below the United Nations target of 0.15-0.20 per cent to be reached by 2015. As of 2009, only seven OECD DAC donors (Belgium, Denmark, Ireland, Luxembourg, the

³² Ten members of ASEAN (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam) and China, Japan and the Republic of Korea.

³³ The data analysis draws heavily on the *MDG Gap Task Force Report 2011: Time to Deliver* (United Nations publication, Sales No E.11.I.11), available from http://www.un.org/en/development/desa/policy/mdg_gap/index.shtml.

Figure III.3
ODA growth rate per annum, 2000-2013



Source: OECD-DAC aid statistics, 2011, available from http://www.oecd.org/document/29/0,3746,en_21571361_44315115_47519517_1_1_1_1,00.html.

^a UN/DESA projections.

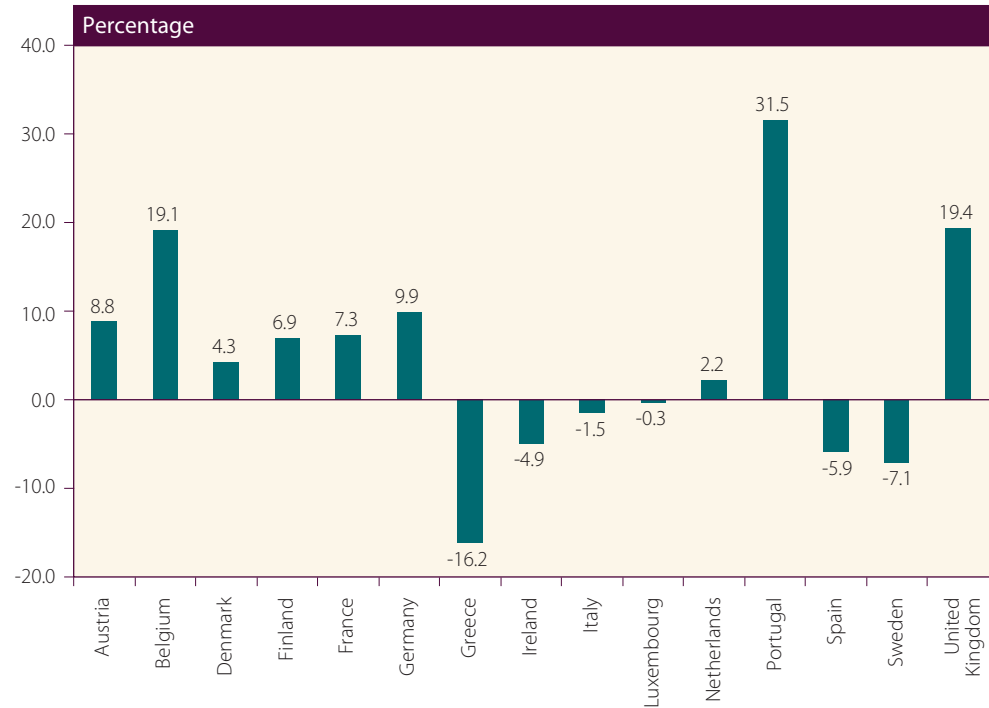
Netherlands, Norway and Sweden) had exceeded the upper bound of the United Nations target and two donors (Finland and the United Kingdom) had surpassed the lower bound of the target. While country programmable aid to the majority of LDCs is projected to increase by a total of \$2.3 billion from 2009 to 2012, 13 countries are likely to face a reduction of about \$0.8 billion, with virtually no growth projected for 2012.

The 2010 Millennium Development Goals (MDGs) Summit, recognizing the shortfalls in ODA delivery, reiterated the critical importance of fulfilling all ODA commitments and encouraged donors to establish specific timetables to reach their pledge targets. Similarly, the May 2011 Istanbul Programme of Action for LDCs called upon donor countries to implement their ODA commitments to LDCs by 2015 and to consider further measures to increase the availability of resources for the most disadvantaged countries. However, the short- and medium-term forecast for increasing ODA looks very uncertain. Given the fragile recovery in developed countries and the possibility of a double-dip recession in Europe, most donors plan to increase aid over the coming three years at a much reduced pace. Whereas ODA from the 15 EU countries had increased slightly from 0.44 per cent of their combined GNI in 2009 to 0.46 per cent in 2010, the ongoing fiscal crises in Greece, Ireland, Italy and Spain have already translated into significant drops in their ODA (figure III.4). According to a recent OECD survey, country programmable aid will grow at 2 per cent per year between 2011 and 2013, compared to the average of 8 per cent per year over the past three years.

On the positive side, grants and the grant element of concessional loans have increased over time, especially in aid directed towards LDCs, their weight having reached 99.3 per cent in 2008-2009, compared to the 96.1 per cent of aid to all recipients. Also, 84 per cent of bilateral aid was classified as untied by 2009, although that share drops to 70 per cent with the inclusion of technical cooperation and food aid.

ODA flows are expected to decelerate in the coming three years

Figure III.4
EU-15 ODA growth rate per annum, 2009-2010



Source: OECD-DAC aid statistics, 2011, available from http://www.oecd.org/document/35/0,3746,en_2649_34447_47515235_1_1_1_1,00.html.

The allocation of aid remains unequal. As of 2009, the top 10 ODA recipients received one fourth of all aid; in 2000, these same countries absorbed about 13 per cent of the total. This suggests that aid concentration persists despite the fact that favoured aid recipients change over time.

The current pattern of aid allocation illustrates the difficulties donors face in meeting multiple priorities in an environment of weakening growth in their aid volume, a situation which, in turn, poses the threat of overlooking critical development needs of the recipient countries. While aid is not the only source funding productive investment, the contribution of aid-financed, productivity-enhancing public investment in developing countries continues to be essential, especially in the LDCs. However, a background study for the 2012 United Nations Development Cooperation Forum (DCF) found that the proportion of aid funding for economic infrastructure in LDCs has hardly changed (4.0 per cent in 2002 to 4.1 per cent in 2009). Furthermore, LDCs with relatively low aid dependence (that is, whose aid receipts are less than 9.2 per cent of their GNI) were the only programme country grouping that received a lower proportion of aid for economic infrastructure in 2009 (0.9 per cent) than in 2002 (1.8 per cent).³⁴

The shortfalls in meeting aid commitments have led to renewed calls to strengthen further the follow-up processes on development cooperation by improving existing global monitoring and evaluation mechanisms and exploring new modalities, such as international peer reviews. The DAC adopted, in April 2011, a “Recommendation on Good Pledging Practice”, advising its members to ensure clarity by specifying in their

³⁴ See, “Trends in international financial cooperation for LDCs”, background study for the 2012 Development Cooperation Forum, draft of 29 April 2011, p. 27, available from http://www.un.org/en/ecosoc/newfunct/pdf/ldc_study-executive_summary_en.pdf.

pledges all parameters relevant to the assessment of the pledges. Related topics were discussed at the High-level Dialogue on Financing for Development of the General Assembly, held in New York from 7 to 9 December 2011, and at the preparatory meetings for the 2012 DCF. Donor States, recipient countries and other relevant stakeholders also met for the Fourth High-Level Forum on Aid Effectiveness (Busan, Republic of Korea, 29 November-1 December 2011) to reassess the aid effectiveness agenda.

In the run-up to the Fourth High-Level Forum on Aid Effectiveness, OECD-DAC conducted an online survey of the priorities and ideas of Governments, donors and non-State actors in over 80 developing countries.³⁵ Alongside calls for the full implementation of the Paris Declaration, the results of the survey called for broadening the agenda to consider more actors, additional sources of finance, and non-aid dimensions of development effectiveness.

The agreement reached by the High-Level Forum in Busan stressed the importance of domestic ownership, greater cooperation between developing countries, improved domestic institutions, South-South cooperation, domestic resource mobilization, and the role of the private sector. Specific commitments in the agreement were made on improving standards for transparency and implementing a common standard for the electronic publication of information on resources by 2015. However, donors did not make new commitments in other areas, such as aid predictability, improving efficiency or untying aid. For example, those donors who made commitments on aid predictability in the Accra Agenda reaffirmed those commitments, but other actors agreed only to aim to provide developing countries with timely and relevant information on their intentions in this area. Donors agreed to accelerate efforts to address insufficient resources by agreeing on principles to guide actions by the end of 2012.

The 2012 DCF will provide an important opportunity to review the issues and the recent trends in international development cooperation, including the coherence of national and international aid efforts and a burgeoning number of potential additional sources of aid, so as to best align aid policies with national development strategies. The debate and activities under the DCF complement those of the Paris and Accra initiatives, and include the second survey on mutual accountability between donors and programme countries and aid transparency at the country level, undertaken with the United Nations Development Programme (UNDP). The DCF is also exploring ways to strengthen developing country policy space and their capacity to monitor and manage results, as well as mutual accountability for development cooperation.

South-South cooperation

ODA from DAC members is increasingly complemented by other programmes of assistance from developing countries and economies in transition. South-South cooperation has helped to meet certain gaps in assistance provided by Northern donors, particularly in the area of infrastructure, and has been seen as relatively predictable, more flexible and responsive to national priorities.³⁶ These flows were estimated to have reached \$7 billion in 2009, although this is believed to grossly understate the total extent of South-South coop-

South-South cooperation has been seen as more reliable and flexible

³⁵ See Organization for Economic Cooperation and Development (OECD) Working Party on Aid Effectiveness, "What do partner countries want from HLF-4? Results of the online consultation", 22 February 2011.

³⁶ "Trends in international financial cooperation for LDCs", op. cit., p. 26.

eration. A study for the World Bank estimated that non-DAC official assistance was in the range of \$12 billion to \$15 billion in 2008.³⁷ Another study undertaken for the DCF has estimated that South-South cooperation flows reached \$15 billion in 2008, an increase of 78 per cent since 2006. In recognition of the growing importance of South-South aid, the DAC Working Party on Aid Effectiveness hosted a Task Team on South-South Cooperation comprising Governments from the North and the South, regional organizations and civil society. The DAC formalized its efforts to forge a global partnership with other key players by issuing, in May 2011, a statement calling for open dialogue without preconditions.

Innovative sources of finance

Innovative sources of development finance (IDF) aim to raise financing for development from sources other than central Government budgets in the developed world, to provide stable and predictable funding sources and to address gaps in the current aid architecture (such as financing for the provisioning of global public goods).

The overall contributions of innovative financing mechanisms are still modest

There has been considerable progress in innovative financing mechanisms since the Monterrey Consensus, although their overall contributions are still modest. During the period 2002-2010, based on the OECD classification, innovative financing mechanisms contributed \$5.5 billion to development finance for the health sector and \$31 billion for climate change and the environment, the latter mostly from carbon emissions trading. Although innovative financing should supplement and not be a substitute for traditional sources of financing, most of the \$5.5 billion raised for the health sector is currently counted as ODA. The resources that have not counted as ODA amounted to only \$0.2 billion of non-government contributions, although even these non-ODA resources may eventually be reported as ODA when they are disbursed.³⁸ Of the \$31 billion raised for climate change and the environment, most represented private financial and investment flows and were, therefore, classified as non-ODA.³⁹

Given the tremendous financing needs of developing countries and the unpredictability of existing aid flows, ways to expand innovative sources of development financing should be explored further and, where appropriate, expanded to complement traditional ODA. Delivery mechanisms and the allocation of aid flows need to be strengthened so that such resources can be provided on a stable, predictable and voluntary basis. Harmonization of fragmented monitoring and evaluation mechanisms is needed to reduce transaction costs. There is also a need for independent monitoring and evaluation at the international level to assess the delivery, allocation and impact of innovative financing on development outcomes.

³⁷ Penny Davies, "A review of the roles and activities of new development partners", CFP Working Paper series, No. 4 (Washington, D.C.: Concessional Finance and Global Partnerships, World Bank, January 2010).

³⁸ United Nations, "Report of the Secretary-General on innovative mechanisms of financing for development", 1 September 2011, A/66/334.

³⁹ There is considerable divergence between the OECD and the World Bank classifications regarding what constitutes innovative financing, and estimates vary as a result. For further details, see United Nations, "Report of the Secretary-General on innovative mechanisms of financing for development", *ibid.*

Developing country debt relief⁴⁰

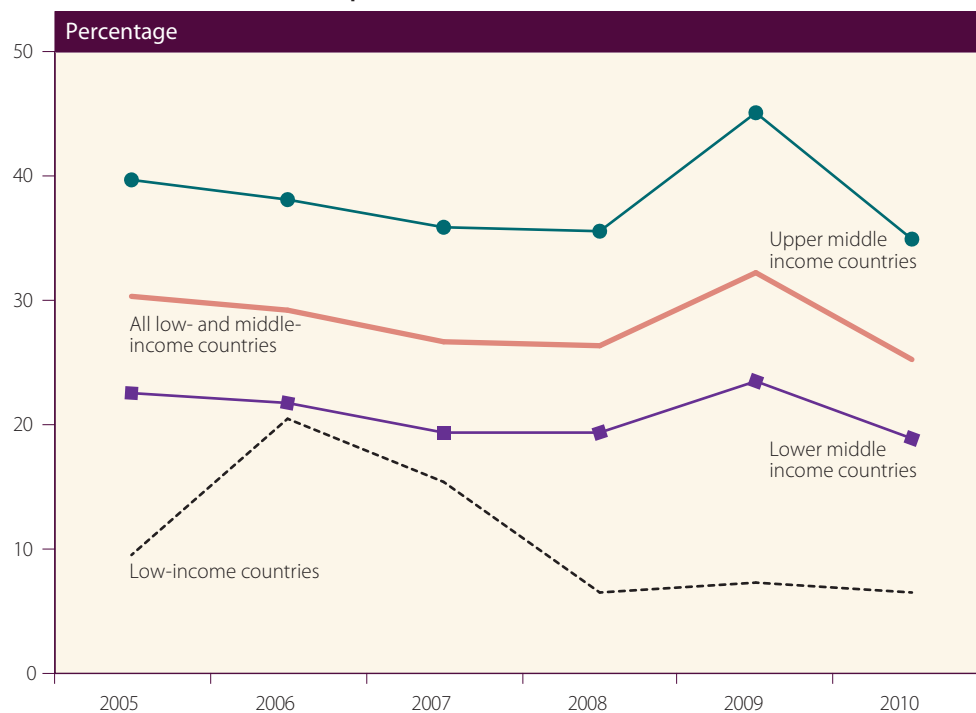
The rise in public expenditure and decreased revenue resulting from the global crisis has led to increased fiscal deficits and borrowing in many developing countries. Across regions, 20 countries remain at high risk of or are already in debt distress.⁴¹ In 2010, 60 countries maintained public debt-to-GDP ratios over 40 per cent (17 low-income countries, 22 lower middle income countries and 21 upper middle income countries).⁴²

Yet, despite an 8 per cent increase in nominal external debt in 2010, the recovery in growth and exports of many developing countries has led to an improvement in debt indicators.⁴³ The ratio of external debt to GDP decreased from 23.7 per cent in 2009 to 21.6 per cent in 2010. Estimates for the ratio of external debt service to exports of goods and services for 2010 also show a return to pre-crisis levels for all income groups, reaching 6.5 per cent in low-income countries, 19 per cent in lower middle income countries and 35 per cent in upper middle income countries, as shown in figure III.5.

In many countries, fiscal deficits have been partly financed through rising domestic debt, which increased to 3.7 per cent of GDP for low-income countries and 4.5 per cent for middle-income countries in 2009. Owing to the economic recovery, however, fiscal deficits decreased slightly in 2010 to 3.6 per cent and 3.7 per cent in low-income and lower middle income countries, respectively. Upper middle income countries have not

The recovery in growth has led to an improvement in debt indicators

Figure III.5
External debt service-to-exports ratio, 2005-2010



Source: International Monetary Fund (IMF) World Economic Outlook, April 2011 database.

Note: The debt service recorded refers to actual payments.

⁴⁰ This section's analysis also draws on the *MDG Gap Task Force Report 2011: Time to Deliver*, op. cit.

⁴¹ IMF, "List of LIC DSAs for PRGT-eligible countries, as of 7 October 2011", available from www.imf.org/external/pubs/ft/dsa/dsalist.pdf.

⁴² Based on IMF, World Economic Outlook database, April 2011.

⁴³ Ibid.

yet recovered the surplus they exhibited until 2008, with a deficit of 3 per cent of GDP in 2010 compared to a surplus of 1 per cent in 2006-2008. The recovery has been uneven, with some countries and regions still coping with large fiscal deficits, especially given the additional shocks of higher food and energy prices.

The HIPC Initiative and MDRI has reduced the debt of 36 countries by over 80 per cent

The Heavily Indebted Poor Countries (HIPC) Initiative, together with the Multilateral Debt Relief Initiative (MDRI), had reduced the debt of 36 post-decision-point heavily indebted poor countries⁴⁴ by over 80 per cent by the end of 2010.⁴⁵ From 1999 to 2010, the aggregated debt-service payments of the 36 post-decision-point countries fell from 18 per cent of exports to 3 per cent, and the present value of debt to GDP declined from 114 per cent to 19 per cent. The fiscal space created by the reduced debt burden has been used, in part, to increase spending for poverty reduction. Related expenditures were projected to have increased from 44 per cent of revenue in 2001 to 57 per cent of revenue in 2010.⁴⁶

The debt sustainability frameworks are under review

The main debt sustainability monitoring instruments—the joint World Bank-IMF Debt Sustainability Framework for low-income countries and the IMF Debt Sustainability Analysis (DSA) for market access countries—are currently under review. Modernizing the framework for fiscal policy and public debt sustainability analysis (DSA) has become necessary, particularly in the light of the recent crisis and rising sustainability concerns in some advanced economies. While recognizing the inherently challenging nature of such analysis, a recent IMF paper recommended that the DSA should be improved through a greater focus on the realism of baseline assumptions, the level of public debt as one of the triggers for further analysis, analysis of fiscal risks, vulnerabilities associated with the debt profile and broader coverage of fiscal balance and public debt.⁴⁷ It also proposes to move to a risk-based approach to DSAs for all market access countries, such that the depth and extent of analysis would be commensurate with concerns regarding sustainability, with a reasonable level of standardization.

In addition to these improvements, it remains crucial that future DSA analysis pay heed to the total liability structure of public and private debt, domestic and external, including contingent liabilities in the financial sector, as well as the purpose and cost-benefit analysis of loans to be taken into account when gauging debt sustainability. Further measures should be taken to improve the data availability and reliability in reporting procedures. Debt problems often occur due to natural disasters, international financial volatility and other exogenous shocks, even when countries have good economic policies and strong debt management. Structural vulnerabilities to shocks can therefore be as important as policy and institutional quality.

The European debt crisis has highlighted the lack of a legal framework for sovereign debt restructuring

The European debt crisis has highlighted the lack of a legal framework for sovereign debt restructuring for countries in debt distress. In general, without a legal framework, sovereign debt restructuring risks being incomplete, drawn out, chaotic and costly. The uncertainty surrounding the process adds risk to the global financial system;

⁴⁴ The number of Multilateral Debt Relief Initiative beneficiary countries is 32, excluding 4 interim heavily indebted poor countries.

⁴⁵ World Bank, "HIPC At-A-Glance Guide (Spring 2011)", (Washington, D.C.), available from <http://www.worldbank.org/economicpolicyanddebt>.

⁴⁶ International Development Association (IDA) and IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of implementation", 14 September 2010.

⁴⁷ IMF, "Modernizing the framework for fiscal policy and public debt sustainability analysis", (Washington, D.C.: IMF Fiscal Affairs Department and Strategy, Policy, and Review Department, 5 August 2011).

this risk has been cited as one of the reasons why countries feel the need to build reserves.⁴⁸ A sovereign bankruptcy framework, with a fair arbiter, could thus be an important element in reducing global risk.

In addition, current debt relief and restructuring approaches have not paid sufficient attention to basic growth requirements and the expansion of policy space genuinely needed to overcome debt distress. The Paris Club of official creditors' arrangement calls into question a process in which an ad hoc committee of creditors passes judgement on debtor country obligations. The share of creditors that are members of the Paris Club in total debt has become relatively small, owing to increased borrowing from multilateral, private sector and emerging market creditors and earlier debt-reduction operations provided by the Paris Club. Paris Club lenders accounted for 20 per cent and 13 per cent of the debt for low-income and lower middle income countries in 2009, while their share for upper middle income countries was only 2 per cent.⁴⁹ Since flows from non-Paris Club creditors are on the rise, new modalities may be needed to deal with problems in debt owed by emerging economies and developing countries to non-Paris Club creditors. In addition, the legal basis for private and official non-Paris Club creditors to provide treatment comparable to that of the Paris Club is weak and non-binding.

There are also issues related to the transparency and efficiency of the process, such as problems in debt data reconciliation and the interest rate at which debt rescheduling is carried out. Furthermore, there are possible conflicts of interest between the role of the IMF as a preferential creditor in official debt restructuring, on the one hand, and its role in assessing the financing gap to be filled by the Paris Club, on the other. There are also numerous other conflicts of interest in the debt restructuring process that are difficult to resolve with some form of adjudication.

The outcome document of the 2010 MDG Summit called for the consideration of an enhanced approach to debt restructuring, but no action has been taken so far. The establishment of a more permanent debt-restructuring machinery that would invite all creditors to deal simultaneously and comprehensively with a debtor country's difficulties, as needed, could resolve many of the shortcomings in the existing system. An international mechanism could be empowered to adjudicate disputes if informal negotiations fail. Other difficulties that it could address pertain to the delay and attendant high costs in finding a resolution, as well as the lack of comprehensiveness in dealing with all liabilities. The system needs to be fairer and to be able to work out debt problems in a more timely and effective manner. Going forward, the practical options for enhancing the financial architecture for debt restructuring could be discussed at the United Nations with the participation of all relevant stakeholders from the official and private sectors.

In more general terms, risk in the international financial system threatens financing for development and has led to a build-up in reserves and a worsening of global imbalances. Reforms of the international system are necessary in order to secure financing and enable development.

⁴⁸ Barry Herman, José Antonio Ocampo and Shari Spiegel, *Overcoming Developing Country Debt Crises* (New York: Oxford University Press, April 2010).

⁴⁹ See Paris Club, available from <http://www.clubdeparis.org/>; and IMF, World Economic Outlook database, April 2011, op. cit.

