

NGO Background Paper on Monterrey Consensus Chapter F

“Addressing Systemic Issues”

The Financing for Development (FFD) Review Conference comes at a welcome time when the major multilateral institutions, the World Bank, the IMF and the WTO, as well as the regional development banks in general, are rethinking their role in finance and development. In this regard, the FFD Review should be taken as a setting for crafting a multilaterally and politically agreed vision and guidance for global and regional economic institutions in charting their future roles, while also identifying the institutional gaps and deficiencies that have helped trigger such crises.

Avoiding financial crises require global cross-border cooperation on supervision and regulation

The still unfolding financial crisis emanating from Wall Street and its consequences shows that systemic problems of the financial system are not a thing of the past. The crises and ensuing credit turmoil have also renewed attention to the drawbacks in credit rating agencies, financial standards (in particular Basel II) and the bodies that design them, and the roles of supervisors and regulators. Unfortunately, measures proposed in the Monterrey Consensus that would have helped prevent the crisis or its unfair consequences remain unheeded. Basel II's approach to capital and solvency measures was very significant in the establishment of incentives for banks that have led to the crisis. The Basel II principles need additional work, in particular regarding the treatment of off-balance sheet claims that have undermined confidence in bank solvency, and the differing needs of banks in developing countries compared to the largest banks in developed countries

It is worth noting that developing countries have been absent from the design of Basel II, but if the outcome of the present crisis is a global recession, they will not be absent at the time of suffering the consequences of its failure. The Monterrey Consensus called for broadening the participation of developing countries in financial standard-setting bodies. Yet, not only in the Basel Committee on Banking Supervision, but also the International Accounting Standards Board, the Organization for Economic Cooperation and Development (corporate governance), the International Association for Insurance Supervisors, the Financial Stability Forum, the Bank for International Settlements, and other bodies that develop such standards and that had a role to play in the making of the current crisis, they are deficiently represented or absent.

The Monterrey Consensus called for credit rating agencies to “maximize the use of strict, objective and transparent parameters” in developing sovereign risk assessments. Not much was done on this aspect, but it is clear that the call is also insufficient. The current crisis has to do with credit ratings on private sector companies and financial products. There is a need to also revamp the incentives structure within rating agencies so they produce more reliable assessments.

The crisis also shows undoubtedly that the time for purely national policy making to contain cross-border risks is over. Cross-border financing requires stronger cross-border supervisory and regulatory efforts. There needs to be greater global cooperation among supervisors and regulators in existing fora and institutions, and eventually through setting up inclusive and comprehensive fora that can provide an effective public sector counterpart to what is now a private international financial sector, spot early problems and call for regulatory reform on emerging areas of risk.

New actors, highly leveraged and nontransparent, such as hedge funds, are a threat to financial stability, and thus to employment and social policies. Appropriate regulations should be implemented to preserve long term and employment-friendly business activities from such short-termist financial behavior.

Global macroeconomic surveillance is failing

The IMF is clearly failing to broker the coordination of exchange rates among major hard-currency issuers - coordination also mandated in the Monterrey Consensus - and the prevention of global imbalances. This function is essential to avoid the impacts of exchange rate volatility on the trading capacity and debt service of developing countries, as when unsustainable global situations begin to correct themselves.

In the absence of adequate and readily accessible emergency financing, developing countries have tried to cope with this volatility by building large amounts of reserves. But this is taking place at huge development and social costs, as such funds are invested in rich-country treasury securities instead of in growth-supporting investment at home. The unwinding of major-currency misalignments may bring large losses to the purchasing power of such reserves. There is a need to move to a less dollar-dependent global monetary system.

Until mechanisms and structures are in place to correct and prevent financial imbalances of global consequence, and to offer semi-automatic liquidity during global instabilities, developing countries should not abandon policies to actively manage their exchange rate. The difficulties created by these exchange rate fluctuations in developing country economies should be acknowledged. An additional mechanism to help cope with global instability could also be provided via the regionalization of finance, initiatives which should be encouraged and supported.

Multilateral and bilateral financing agencies continue to exert enormous influence on the trade and investment negotiating space of countries that receive their financing. The respective agencies should refrain from intruding into areas covered by such negotiations.

Reform of the governance of the Bretton Woods Institutions

Little progress can also be seen in the Monterrey Consensus call for increasing participation by developing countries in economic policy-making institutions, especially the Bretton Woods Institutions (BWI). The discussions so far on the IMF quota formula have lacked ambition, and fall short of the significant revamping of variables required to achieve the political goals promoted in Monterrey. Moreover, they threaten to marginalize even further low-income countries which have become the main users of the IMF.

The ongoing governance reform process should ensure a review of the quota formula that removes elements that systematically underestimate the size of developing country economies (e.g. the measurement of GDP should be done in Purchasing Parity Power terms). Recent World Bank studies have demonstrated that measurement constraints are not a real obstacle to this proposal. The formula should also exclude factors that are highly correlated with GDP. The formula should also incorporate additional measures such as the variability of GDP. "Basic votes", which are given equally to each member country, should be increased so as to ensure the ratio of basic votes to total votes is, at least, equal to that at the time of the founding of the institutions, that is, roughly 10% of the total quotas. An amendment to the IMF Articles of Agreement should ensure periodic indexation of basic votes to total votes, to ensure future quota increases do not erode this proportion.

The Board should be restructured so as to increase the number of developing country Board seats. The constituencies represented by each Executive Director should be reshaped, with a ceiling of no more than 10 countries per constituency being established. In the short term, the practice of noting dissenting votes in the constituency should be formalized and institutionalized as a standard practice.

The use of double-majority voting modalities should be given serious consideration as a tool to increase the weight of borrowing countries in decision-making within the BWIs.

New bodies needed for economic policy coordination

The emergence of a new aid architecture since Monterrey in which donors better coordinate among themselves in practice may have a major negative by-product, that of further limit developing countries from control of decision-making and norm-setting. It flies in the face of the commitment to strengthen participation of developing countries in decision-making. Issues such as what to count as aid, what guidelines to apply in post-conflict situations, how to measure the performance of aid recipients remain as concentrated as ever in the hands of donors or donor-driven forums. The efforts in implementation of the Paris Declaration have not provided adequate institutional setting for negotiations with the developing countries. A much more adequate forum for such discussions, the emerging ECOSOC *Development Cooperation Forum*, needs to be strongly supported so it can provide the adequate institutional setting that is required. The Doha Review should seriously consider assigning norm-setting responsibility on critical issues that define aid policy to this forum.

In spite of the Monterrey Consensus demands for strengthening their tax cooperation and reducing capital flight, capital flight and tax evasion continue to drain much-needed resources for development. Responsibility lies with both source and recipient countries of such capital. There needs to be a routine exchange of tax information between governments in order to combat tax evasion and other illicit transfers of funds. Much greater transparency is essential in all financial institutions, especially those that provide services privately, such as hedge funds, private equity and sovereign wealth funds, so tax liabilities can be properly assessed and collected. Cross-border tax evasion should be treated as a suspicious activity which must be reported to the relevant government authorities. Tax havens need to be closed as they only serve the interests of tax avoiders and criminals. Therefore, the *United Nations Committee on International Cooperation in Tax Matters* should be strengthened and converted into an intergovernmental entity, complete with adequate technical staff. The agenda of the UN Tax Committee must include measures to combat capital flight and tax evasion in developing countries, and also measures to assist developing countries to improve their tax administration. In the long run, a World Tax Organization (proposed in 2001 by a UN panel chaired by Ernesto Zedillo, former President of Mexico) should be established for deepening international dialog among national tax authorities and enhancing the coherence of activities of multilateral and regional organizations.

There has been slight progress in the Monterrey Consensus commitment, reaffirmed in the 2005 Summit Outcome Document, for considering an international *debt workout mechanism* to promote fair burden sharing in sovereign debt crises and minimize moral hazard. It must be strengthened. The increasingly diverse set of lenders and instruments of sovereign debt has made existing ad hoc debt negotiation fora more obsolete than they were already in 2002. Efforts towards comprehensive and effective debt workouts need to be revived in the framework of the Doha follow-up process.

The follow-up process has proved weak and lacking the robustness that would be faithful to the Monterrey Consensus commitment to ensure continued engagement of all development stakeholders, including at key Ministerial levels, at the highest level, under the auspices of the UN. There is a need to strengthen the intergovernmental process by establishing a General Assembly intergovernmental *Committee on Financing for Development*. But this will not be enough to revive momentum in the FFD process. The follow up needs to establish a place for decision-makers at Ministerial level to meet on a regular and ongoing basis to evaluate progress in implementation of the Monterrey Consensus and take steps to advance it.

A “*Global Leaders Forum*” with balanced geographical representation under the auspices of the UN should be established to upgrade policy coordination to enhance coherence and consistency of international monetary, financial and trading systems (proposed by UN panel on “System-wide Coherence” in 2006).

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