Chapter 3
International finance for development

There is increasing awareness that substantial financing will be needed to meet global development challenges, such as mitigating the effects of climate change and achieving the Millennium Development Goals (MDGs). Given the scope of the financing needs, both private and public sector funds will be necessary, underscoring the importance of having sound financial sectors capable of providing stable long-term financing for sustainable development.

Yet, four years after the crisis began, the international financial system continues to be plagued by vulnerabilities. The sovereign debt crisis in Europe and the uneven global recovery have led to heightened risk aversion and increased volatility of private capital flows (see chapter I). Deleveraging of financial institutions continues, particularly in Europe, where many banks hold large amounts of sovereign bonds from debt-distressed countries on their balance sheets. In recipient countries, flows of official development assistance (ODA) also tend to be highly volatile. In 2011, total ODA flows, net of debt cancellation, fell in real terms for the first time since 1997, owing to greater fiscal austerity and sovereign debt problems in developed countries. At the same time, institutional investors appear to have become increasingly oriented to the short term, with fewer resources dedicated to long-term investments since the crisis.

The international community has taken steps to address some of these vulnerabilities by strengthening the banking system through regulatory reforms. Although these reforms represent important steps forward, they are being phased in only gradually, are not comprehensive, and are not adequately focused on the underlying goal of the financial system to effectively allocate credit for long-term sustainable development. This chapter discusses the underlying risks in the international financial system and its possible impact on financing for sustainable development.

Trends in private capital and other private flows

In 2012, net international private capital flows to developing countries and economies in transition fell by more than 50 per cent, from $425 billion in 2011 to an estimated $206 billion in 2012 (table III.1). More broadly, private capital flows have been highly volatile since 2008. Net private capital inflows collapsed during the crisis, surged in 2010 to approximately $525 billion, and declined again in the latter part of 2011. While some stability seemed to return to international currency and capital markets in early 2012, new turmoil surfaced later in the year.

This heightened volatility can be attributed to several factors. An increase in global risk aversion, caused in part by growing fears about the sustainability of public finances in Europe, is leading portfolio investors to a general flight to safety. In addition, many European banks continue to face deleveraging pressures, which has led to cutbacks in lending to developing and transition economies. There is a risk that deleveraging pressures will worsen if the European crisis accelerates, which could in turn trigger significant portfolio outflows from emerging economies. A tightening in lending standards by international banks in response to Basel III might also force further deleveraging, although
such an effect is likely to be rather muted because of the long phase-in period of some of its elements. In addition, signs of an economic slowdown in some leading developing economies (like Brazil, China and India) have reduced flows to these countries.

At the same time, other factors have encouraged increased inflows into developing countries. Weaknesses in developed economies have led some investors to diversify out of troubled advanced economy markets and into developing country markets. In addition, extremely high global liquidity brought on by the exceptional monetary policy measures imposed in response to the crisis—such as the third round of quantitative easing in the United States—has depressed yields in some developed countries to close to zero. As a result, a search for better yields has led to an increase in short-term investments in countries with higher interest rates (often referred to as the carry trade).

This diverse set of pressures has created increased volatility and impacted different types of flows in different ways. Overall, given that much of the positive inflows are driven by a search for short-term yields resulting from low interest rates in developed countries, fixed-income investments have experienced more positive trends than equity portfolio investment and foreign direct investment (FDI).

Table III.1
Net financial flows to developing countries and economies in transition, 1999-2013

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<td>-94.3</td>
<td>-33.6</td>
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<tr>
<td>Total net flows</td>
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<td>111.6</td>
<td>458.3</td>
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<td>330.4</td>
<td>169.7</td>
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<td>-636.9</td>
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<tr>
<td>East and South Asia</td>
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<tr>
<td>Net private capital flows</td>
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<td>99.6</td>
<td>301.0</td>
<td>387.2</td>
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<td>193.2</td>
<td>224.4</td>
<td>171.2</td>
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<td>Net official flows</td>
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<tr>
<td>Total net flows</td>
<td>15.5</td>
<td>93.1</td>
<td>320.4</td>
<td>403.0</td>
<td>218.0</td>
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<td>-689.9</td>
<td>-525.5</td>
<td>-254.5</td>
<td>-373.6</td>
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</table>

The recent decline in international capital inflows has been mainly on account of a collapse in cross-border interbank flows (referenced under “net private flows” in table III.1), as well as a drop in equity portfolio flows. Although commercial bank lending to developing countries had been following a path of gradual recovery in many countries, deleveraging pressures continue to be felt, especially from European banks. The impact of declining cross-border bank lending has been greatest in emerging Europe and Central Asia, which...
have the most direct exposures to banks in the European Union (EU). There is evidence that deleveraging in the European banking sector has especially affected trade financing, which in many countries comprises a large share of short-term borrowing. Trade-oriented small- and medium-sized enterprises (SMEs) from lower-income countries, in particular, have faced a sharp shortfall in funding.

In contrast, developing country fixed-income instruments have become more attractive to investors in recent months. Sovereign bond spreads on emerging market external debt tightened in the second half of 2012 from over 400 basis points at the beginning of June to about 290 basis points in late-November, indicating an increase in demand (see chapter I, figure I.10). Similarly, more capital has moved towards domestic bond markets of developing countries. There is also evidence that investors chose to hedge currency risk selectively rather than withdraw from the developing country bond markets—which limit portfolio bond outflows during spells of heightened risk aversion—although this could reflect illiquidity in some domestic bond markets, not sustained demand for the products.

**Foreign direct investment**

FDI tends to be more stable than portfolio investment and bank lending (although the volatility of FDI flows increased somewhat in recent years, as discussed below). FDI remains a major component of private capital flows to developing countries. While FDI rose sharply in 2011, reaching approximately $436 billion, it fell in the latter part of the year, as well as in 2012. Furthermore, FDI remains concentrated in a few regions and countries. Most FDI flowing to developing countries is going to Asia and Latin America. Only 10 per cent of inward FDI goes to Africa. Furthermore, the distribution of FDI flows within Africa remains uneven, with more than 80 per cent of the capital going to natural resource-rich economies. Nonetheless, FDI comprises the dominant share of private capital flows to LDCs.

Outward FDI from developing and transition economies has become increasingly significant, with a large proportion directed towards other developing and transition economies. However, their share in global FDI outflows declined from 31 per cent in 2010 to 26 per cent in 2011, mainly owing to a significant decline in outward FDI from Latin America and the Caribbean as foreign affiliates of some Latin American transnational companies repaid loans to their parent firms. Nevertheless, the overall levels of FDI flowing from developing and transition economies remained high from a historical perspective.

**Remittances**

Remittances from workers abroad have continued increasing and for many developing countries have become a critical source of foreign-exchange earnings. Income from worker remittances as recorded in balance-of-payments statistics totalled $406 billion in 2012, representing a year-on-year increase of about 6.5 per cent. For some countries, it is a

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4 This could be partly owing to Basel III regulations on trade finance, as may be inferred from data presented in World Bank, *Global Economic Prospects: Managing growth in a volatile world*, June 2012, Finance annex, pp. 43-51.
7 The real size of remittances, though, is probably larger, given that many remittances are channelled through informal mechanisms that are not recorded.
main source of income. For instance, remittances were as high as 47 per cent of GDP in Tajikistan, 27 per cent in Lesotho, and around 20 per cent of gross domestic product (GDP) in the Republic of Moldova, Samoa and Kosovo.8

The total volume of remittance flows to developing countries moderated somewhat during the initial years of the global economic and financial crisis, but the decline was not as sharp as in the case of private capital inflows. In general, remittance flows tend to be less volatile than most forms of cross-border financial flows. Yet, the economic slowdown and rise in unemployment in Europe disproportionately affects migrant workers, especially in Italy and Spain. This in turn has had a strongly adverse impact on remittance flows to Eastern European countries, such as Bosnia and Herzegovina, Poland and Romania, as well as countries in the Middle East and North Africa,9 and some in Latin America, like Ecuador and, to a lesser extent, Colombia.

The total volume of worker remittance flows to developing countries was more than three times the size of ODA. Remittances should not be seen as an immediate substitute for ODA, however. ODA represents financial flows in support of international development cooperation and is mainly channelled through government budgets. Remittances flow directly to private households, who mainly use the additional income for consumption. A number of Governments and international organizations have taken initiatives providing incentives for using remittance income for investment purposes. For example, the Multilateral Investment Fund of the Inter-American Development Bank offers supplementary grants if remittances are channelled towards investments in housing and other forms of capital formation, education, entrepreneurship training, and research and knowledge dissemination. This way, remittances can become an important and relatively stable form for financing development.

**Shortening maturities**

The high volatility of most types of cross-border capital flows is indicative of the short-term behaviour of investors. Whereas 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, most 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. A range of incentives drive this investor behaviour, including the compensation packages of hedge fund managers and other investment managers, who are paid annually, based on short-term performance, as well as financial management strategies that focus on the short-term share price.10 In addition, risk models used by the financial industry (such as the “value at risk” model) exacerbate the problem, since they are generally based on short-term indicators and do not consider longer-term factors like tail risks (that is, the risk of rare but costly events).

The recent crisis, however, appears to have strengthened this short-term behaviour. The sum of professionally managed assets across the globe totalled about $65 trillion in 2009, of which about $27 trillion was owned by institutional investors such as pension

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8 World Bank, “Remittances to developing countries will surpass $400 billion in 2012”, Migration and Development Brief, No. 19 (20 November 2012).

9 Ibid.

funds. Constraints faced by these investors allowed only a quarter of their assets to be used for long-term ventures.\textsuperscript{11} According to analysis undertaken by the World Economic Forum (WEF), a number of institutional investors experienced difficulty refinancing liabilities during the crisis, which led them to reassess the extent to which they should undertake long-term investments. This, in combination with other factors—including a move towards “mark-to-market” accounting, which requires that long-term illiquid portfolios be evaluated relative to a public market benchmark, stricter capital requirements and the existing structure of staff evaluation, compensation schemes and internal decision-making—is argued to have restricted the proportion of assets employed by these investors for long-term investing.\textsuperscript{12} The WEF study foresees a continuing decline in long-term investing, which will only be partly offset by increasing activity of other investors, such as endowments and foundations, which were also under stress following margin calls on levered investment during the financial crisis.

In light of these trends, there may be a need for policymakers to reconsider the impact of regulatory actions, including mark-to-market accounting, on long-term investment decisions. It also seems important to have a regulatory framework that better manages global liquidity and is conducive to long-term investments, as discussed below. At the same time, institutional investors should develop appropriate liquidity management tools, performance measurement and staff evaluation/compensation mechanisms that provide greater incentives to taking a longer investment horizon.

A further concern is that FDI is becoming more short-term-oriented and that its changing composition could be making it more volatile.\textsuperscript{13} The shift in the composition of FDI from equity to debt components has made it easier for investors to move resources between host and home countries.\textsuperscript{14} Where a significant portion of FDI comprises intracompany debt, as opposed to greenfield direct investments, the parent company can recall this debt on short notice. In this respect, the proportion of short-term and volatile flows in FDI has increased.\textsuperscript{15} Part of the growth in FDI flows during the past two years may have been made for the purpose of short-term gains. It is important that policymakers are cognizant of the growing proportion of short-term investments contained within FDI, which could reverse more quickly than expected in an uncertain economic and financial climate.

\section*{Management of volatile cross-border capital flows}

The volatility associated with short-term capital flows has given greater attention to the issue of how countries should manage cross-border risks. Capital account management has gained greater acceptance as a prudent policy measure by the international community.

\begin{itemize}
\item \textsuperscript{13} United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2011: Non-equity Modes of International Production and Development (United Nations publication, Sales No. E.11.II.D.2).
\item \textsuperscript{14} Jonathan D. Ostry and others, “Managing capital inflows: what tools to use”, IMF Staff Discussion Note, No. SDN11/06 (Washington, D.C., April 2011).
\item \textsuperscript{15} UNCTAD, World Investment Report 2011, op. cit.
\end{itemize}
Indeed, over the past several years a number of developing countries (including Brazil, Indonesia, Peru, the Republic of Korea and Thailand) have introduced capital-account regulatory measures to contain volatile short-term capital flows, as reported in the *World Economic Situation and Prospects 2012*.

Conventional approaches to managing capital inflows focus on macroeconomic policies, such as the exchange-rate adjustment, manipulating policy interest rates and fiscal aggregate demand management, to enhance an economy’s capacity to absorb capital inflows. However, these policies are generally not sufficiently targeted to stabilize financial flows and may have undesired side effects. Letting the exchange rate appreciate, for instance, would penalize export-oriented sectors, thus impacting growth and development. Fiscal cuts to lower aggregate demand can be costly to economic growth and the slow speed of fiscal decision-making makes it a less effective policy tool for dealing with short-term volatile capital inflows. Attempts by policymakers to counteract the expansionary impact of excessive capital inflows through tightening monetary policies could be partly self-defeating as the higher interest rates may induce additional capital inflows, thus exacerbating upward pressure on the exchange rate.

To stem capital inflows and excessive credit growth, countries can implement macroprudential measures including the maintenance of sound lending standards, countercyclical capital requirements to slow down credit expansion, and balance sheet restrictions such as limiting the foreign exchange positions of banks. While these measures appear to have lengthened the composition of capital inflows in some countries (Croatia, Peru and the Republic of Korea, for example), the effect on total net flows was limited. In Peru, where there is a large amount of dollarization in the economy mediated through the banking system, macroprudential measures, such as limits on foreign-exchange mismatches, have been relatively effective at reducing risks. In the Republic of Korea, a package of macroprudential measures was introduced during 2009-2010 that appears to have brought about the intended deceleration in banks’ foreign borrowing, but it did not stem the overall level of capital inflows.

Other countries, like Brazil and Indonesia, have opted to use more direct forms of capital-account regulation. Most available studies find that capital controls have been effective in changing the composition of inflows away from short-term debt. The impact on total flows is more ambiguous, with regulations appearing to have been more successful in some cases than in others.\footnote{See, for example, Jonathan D. Ostry and others, “Capital inflows: the role of controls”, IMF Staff Position Note, No. SPN10/04 (Washington, D.C., February 2010).} More broadly, the effectiveness of measures depends on the specific circumstances of a country, including the quality of the existing regulatory framework and regulatory capacity, the structure and persistence of inflows, and the design and implementation of capital flow management measures. In particular, capital-account regulation may be particularly difficult to implement in countries where there is a large derivatives market, since speculators can often circumvent the restrictions through this market. For this reason, some countries, like Brazil, have implemented restrictions directly in the derivatives market to test the market, albeit at an initial low rate. Overall, there is no simple recipe for effectively managing cross-border capital flows. Macroeconomic policies, macroprudential tools and capital-account regulations should probably come in a balanced package of measures and be tailored to the specific circumstances of individual countries.

As discussed above, one of the drivers of recent surges in international capital flows has been monetary easing in developed countries. Given the cross-border spillover effect of monetary policy decisions, measures that incentivize investors in developed countries to invest at home would help monetary authorities respond to slowdowns in...
developed countries and also help allay pressures for asset bubbles in developing countries. Thus, there is a need for capital-account management in developed as well as developing countries. To this end, central banks may need to step up their international dialogue and cooperation on managing global liquidity. Better management of global liquidity would also have the effect of helping to correct global imbalances.

**International reserve accumulation and global imbalances**

Bouts of excessive international liquidity have been part and parcel of the build-up in global imbalances, with surges and withdrawals of international capital flows correlated with the build-up of reserves by developing countries (although trade balances also play a role in some countries). Reserve holdings of developing and emerging countries as a proportion of national output more than doubled between 1999 and 2008, a period of high global liquidity. The accumulation of vast dollar reserves over this period allowed the United States to borrow cheaply from abroad, keeping long-term interest rates low, which in turn has induced greater leverage in the system. Reserve accumulation peaked at $1.2 trillion in 2007 prior to the crisis, but fell as a percentage of GDP in the years since (with the exception of 2010), following trends in capital flows. In 2012, reserve accumulation fell to an estimated $559 billion, down from $777 billion in 2011, mirroring the decline in capital inflows (see table III.1 for the change in reserve holdings and figure III.1 for stocks as a share of GDP).

Figure III.1
Ratio of reserves to GDP, 1991-2012

<table>
<thead>
<tr>
<th>Percentage</th>
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<tr>
<td>Western Asia</td>
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<tr>
<td>Latin America</td>
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<td>East and South Asia</td>
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<tr>
<td>Africa</td>
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<td>Emerging and developing countries</td>
</tr>
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</table>

**Source**: IMF, World Economic Outlook database, April 2012.
Data not available on WEO October 2012 database.

**Notes**: Regional groupings are based on UN/DESA country classification. No data from 1980–1989 on reserves for newly industrialized economies (Hong Kong SAR, Rep. of Korea, Singapore, Taiwan POC).

* Data for 2012 are WEO forecasts.

Reserve accumulation by developing countries has fallen along with the moderation in global imbalances, although as pointed out in Chapter I, this trend is related to overall weakness in global demand rather than to long-term structural adjustments (see
chapter I, figure I.13). Nonetheless, accumulated reserve holdings remain significant, particularly in South-East Asia, where they amount to almost 40 per cent of GDP (figure III.1).

The massive build-up of reserves by emerging and developing countries and its effect on global stability has raised questions regarding the appropriate size of reserves. The build-up has been attributed to several factors. First, reserves serve as a form of “self-insurance” against potential external shocks. Second, they facilitate interventions in foreign-exchange markets to smooth exchange-rate or commodity price volatility and mitigate bubbles associated with excessive inflows. Third, reserves can be a by-product of export-led growth strategies that rely on interventions in the currency market to maintain an undervalued currency—actions sometimes considered to be mercantilist.\footnote{17} Perspectives on determining the adequate size of international reserves have changed over time. In the 1980s and 1990s, reserves were insurance against trade shocks. At that time, the International Monetary Fund (IMF) advised countries to hold reserves large enough to cover three months of imports. However, the emerging market crises in the mid-1990s, such as the Mexican “tequila crisis”, were triggered by difficulties in refinancing short-term dollar-denominated debt, not unexpected trade account deficits. This led to the view that reserves would need to be large enough to cover a country’s short-term external debt refinancing needs. This approach did not consider, however, the fact that the emerging market crises of the 1990s were also triggered by reversals in short-term capital portfolio flows and the unwinding of carry trades. By the end of the 1990s, countries realized the importance of fuller self-insurance, not just against refinancing risks of external debt, but also against volatility associated with international capital flows and open capital accounts.

Empirical studies suggest that no single explanation can account for the behaviour of all countries at all times. A recent IMF study found that precautionary demand and self-insurance motives both played a prominent role in the increase in international reserves following the East Asian crisis, although mercantilism, in the form of an undervalued real exchange rate, appears to have contributed in some cases.\footnote{18} The study also found a positive unexplained residual in more recent years, implying that reserves were higher than what would be predicted by precautionary or mercantilist motives. This is in keeping with the role of exchange-rate management in smoothing volatility in reserve accumulation. There is some evidence of this, in that central banks have been using capital management techniques to limit capital inflows rather than solely buying the inflows to build reserves in cases when the currency is not undervalued. The goal is not to keep an undervalued currency, but to stop the continued appreciation of an overvalued one while limiting the build-up in reserves.

Clearly, holding large international reserves can be costly, and for a host of reasons. First, most international reserves are held in United States treasuries, which are considered safe but are low-yielding. Foreign-exchange reserves represent a form of constrained saving, since national savings that are allocated to reserves withhold funds that could be invested elsewhere, possibly with greater social benefit. Second, accumulation of foreign-exchange reserves tends to increase the domestic money supply because the central bank buys foreign currency and sells local currency. Attempts to sterilize this increase in the money supply generally involve issuing government bonds to absorb the excess liquidity.


\footnote{18}{Ibid.}
which leads to higher domestic interest rates and thereby raises borrowing costs. Further, the increased bond issuance can lead to a worsening in the domestic public debt burden. The result is that foreign currency inflows end up being held as reserves which in turn are invested in United States Treasury bonds, while the developing country increases its debt burden to finance domestic investment, counteracting the benefit of foreign investment.

That a large share of international reserves is invested in government bonds and similar assets abroad implies a net transfer of resources from poorer countries to wealthier ones. Accumulation of major reserve currencies in developing countries is a major element in the net transfer of financial resources from developing countries to the major economies issuing the reserve currencies (table III.2 and figure III.2). Although net transfers decreased somewhat in 2012 in line with the lower accumulation of reserves, they remained negative, with the exception of the LDCs, which continue to receive net positive transfers.

Finally, precautionary reserve accumulation, while sensible at the national level, generates fallacy of composition effects at the global level, further adding to global imbalances and a less stable international financial architecture as discussed above. The Commission of Experts of the President of the United Nations General Assembly has recommended that the international reserve system make greater use of IMF Special Drawing Rights (SDRs) as these provide a low-cost alternative to accumulation of international reserves. SDRs could reduce the need for precautionary reserve accumulation by providing access to foreign currency liquidity when a country’s capital account is under pressure. In other words, the greater use of SDRs could reduce the need for self-insurance by many developing countries.

There have also been recommendations for mechanisms to use SDR allocations as a potential source of innovative financing for development, although care needs to be taken to preserve the role of SDRs as a monetary instrument, as discussed further below.

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The Group of Twenty (G20) is considering enhancing the SDR basket to include additional currencies and possibly increasing allocations of SDRs. There is, however, political resistance and legal barrier to broadening the scope of SDRs. For example, the IMF Articles would need to be amended to change the way SDRs are allocated, and an 85 per cent majority is needed for agreement regarding new allocations. Instead, international reforms have been more narrowly focused on reducing systemic risks created by the banking sector.

**International financial reform**

There are several regulatory reforms underway, which are designed to reduce the risk of future financial sector crises (table III.2). The current approach to international financial reform has been focused on ensuring the safety and soundness of the financial system, focused primarily on the banking sector through Basel III. This is supplemented by national rule-setting (such as, the “Volcker rule” in the United States of America and the Vickers Commission proposals in the United Kingdom of Great Britain and Northern Ireland) that partially separate the banking sector from shadow banking (box III.2). In addition, the Financial Stability Board (FSB) has proposed a number of measures: reforms for oversight of the shadow banking system; recovery and resolution planning for systemically important institutions; reform of the over-the-counter derivatives market; uniform global accounting standards; reduction in the reliance on credit rating agencies; improved consumer protection; reform of some compensation practices; and the establishment of macroprudential regulatory frameworks. Taken together, these reforms are steps in the right direction. However, significant gaps remain. Indeed, a recent study by the IMF found that the structure of financial intermediation remains more or less the same as it was before the crisis, with excessive reliance on wholesale funding (which tends to be riskier than financing through deposits), and on trading, commission and fee income rather than on lending and credit intermediation.20

Broadly speaking, the objectives of financial sector regulation are fivefold: (i) to secure the safety and soundness of financial institutions and the financial system at large; (ii) to ensure competition; (iii) to protect consumers; (iv) to promote access to finance and financial services for all; and (v) to make certain that the financial sector promotes macroeconomic stability and long-term sustainable growth.21 In addition, a key lesson from the crisis is that rules need to address systemically important institutions and should be comprehensive—in other words, incorporate all facets of credit intermediation.

To date, the reform agenda has not focused sufficiently on all of the objectives. The primary focus has been on safety and soundness. There have been some efforts to improve consumer protection by the FSB, in addition to steps taken on the national level, such as the Consumer Protection Agency in the United States, although these efforts are facing some implementation difficulties. However, the new regulatory framework might have the effect of weakening some of the other principal objectives. For example, the global crisis led to increased consolidation of commercial banks. There is some concern that the new regulatory framework will lead to even greater consolidation to accommodate the need for economies of scale, further limiting competition in the sector as well as exacerbating problems inherent in having “too big to fail” institutions. Furthermore, by raising the cost of riskier lending, capital adequacy rules might have the effect of limiting

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### Table III.2
## A snapshot of the new regulatory initiatives

<table>
<thead>
<tr>
<th>Key reforms</th>
<th>Elements</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banks</strong></td>
<td></td>
<td></td>
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<tr>
<td>Global reforms</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basel III capital standards</td>
<td>Changes to the definition of capital</td>
<td>Completion 2019</td>
</tr>
<tr>
<td>Basel III capital charges</td>
<td>Better valuation of risk</td>
<td>Completion 2019</td>
</tr>
<tr>
<td></td>
<td>Incremental risk charge for trading-book activity</td>
<td>Completion 2019</td>
</tr>
<tr>
<td></td>
<td>Higher capital charges for counterparty exposures in derivatives, repo trading</td>
<td>Completion 2019</td>
</tr>
<tr>
<td></td>
<td>Additional capital conservation and countercyclical buffers</td>
<td>Completion 2019</td>
</tr>
<tr>
<td></td>
<td>Additional capital surcharge for G-SIFIs</td>
<td>Completion 2019</td>
</tr>
<tr>
<td></td>
<td>Capital charge assessed on (clearing member) banks’ central counterparty default fund exposures</td>
<td>Completion 2019</td>
</tr>
<tr>
<td>G-SIFI surcharge</td>
<td>Additional amount of common equity for systemically important banks</td>
<td>Completion 2019</td>
</tr>
<tr>
<td>Basel III liquidity requirements</td>
<td>Liquidity coverage ratio: requires high-quality liquid assets sufficient to meet 30 days’ outflows</td>
<td>Completion 2019</td>
</tr>
<tr>
<td></td>
<td>Net stable funding ratio: requires better maturity matching of assets and liabilities</td>
<td>Completion 2018</td>
</tr>
<tr>
<td>Basel III leverage ratio</td>
<td>Sets a ceiling on the measure of exposures (regardless of risk weighting) against capital (3 percent Tier 1 capital over total exposures)</td>
<td>Completion 2019</td>
</tr>
<tr>
<td>FSB compensation guidelines</td>
<td>Responsibility of boards for compensation policies</td>
<td>Implemented</td>
</tr>
<tr>
<td></td>
<td>Compensation should be aligned with risks and time horizons</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Supervisors should monitor compensation policies</td>
<td></td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Emphasis on robust corporate governance, including the role of banks’ boards</td>
<td></td>
</tr>
<tr>
<td>Resolution of G-SIFIs</td>
<td>Reduce the likelihood that institutions will need to use public funds when they fail</td>
<td></td>
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<tr>
<td>National reforms</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volcker rule (Dodd-Frank Act)</td>
<td>Deposit-taking institutions restricted from trading activities, ownership of private equity and hedge funds</td>
<td>Law passed, implementation pending</td>
</tr>
<tr>
<td>Vickers report</td>
<td>Ring-fencing of United Kingdom retail banks from investment banking activities; additional capital for ring-fenced entity</td>
<td>Completion 2019</td>
</tr>
<tr>
<td>Markets</td>
<td></td>
<td></td>
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<tr>
<td>Global reforms</td>
<td></td>
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<tr>
<td>OTC derivatives</td>
<td>Standardization of derivatives contracts</td>
<td>Varied</td>
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<td></td>
<td>Clearing of standardized derivatives contracts through central counterparties (CCPs)</td>
<td></td>
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<tr>
<td></td>
<td>Trading of standardized derivatives contracts on exchanges or electronic trading platforms where appropriate</td>
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<td></td>
<td>Reporting of contracts to trade repositories</td>
<td></td>
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<tr>
<td></td>
<td>Higher capital and margin requirements for derivatives that are not centrally cleared</td>
<td></td>
</tr>
</tbody>
</table>
### Table III.2 (cont’d)

<table>
<thead>
<tr>
<th>Key reforms</th>
<th>Elements</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nonbanks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Global reforms</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shadow banking</td>
<td>Monitoring of shadow banking and evaluation of risks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Registration of hedge funds; improved standards for securitization</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Future regulatory reforms include enhancements to indirect regulation (regulation of shadow banks through their interaction with banks); increased liquidity and valuation rules for money market funds; rules governing repos and securities lending</td>
<td></td>
</tr>
<tr>
<td><strong>Other initiatives</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit ratings</td>
<td>Registration and regulation of credit rating agencies; regulation includes further transparency on rating methodologies, on the performance of ratings, and raw data</td>
<td>Implementation ongoing</td>
</tr>
<tr>
<td></td>
<td>Reduction of regulatory reliance on ratings; in the United States, this has triggered removal of references to credit ratings in laws and regulations</td>
<td>Implementation ongoing</td>
</tr>
</tbody>
</table>


**Note:** No entry for timeline means that the reforms are still being developed. FSB = Financial Stability Board; G-SIFIs = global systemically important financial institutions.

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### What is shadow banking?

The Financial Stability Board defines shadow banking as “credit intermediation involving entities and activities outside the regular banking system.” Shadow banking entities are those that create leverage or that engage in maturity and liquidity transformation.

The shadow banking sector is markedly different in developed than in developing countries. In developed countries, non-bank financial intermediation is mainly conducted by money market funds, structured finance vehicles, other investment funds including hedge, investment, and exchange-traded funds, finance companies, insurance companies, and securities brokers and dealers. These entities engage in credit intermediation through activities and instruments including securitization, securities lending, derivatives, repurchase agreements and loans, thus partly competing with banks that are relatively more strictly regulated and supervised.

The share of the United States in global shadow banking declined from 44 per cent in 2005 to 35 per cent in 2011, but its shadow banking sector remains the largest worldwide, at over 50 per cent of credit intermediation. In the euro area, shadow banking represented less than 30 per cent of credit intermediation in 2010. Important differences remain across countries, however. The Netherlands, Luxembourg, France and Ireland account for around three quarters of shadow banking activity in the euro area.

Currently, shadow banking is of much less concern in developing economies, though it could become more of an issue if it continues to grow or engages in products without proper regulations. In developing countries, funding is currently channelled from investors to creditors, bypassing banks through entities such as finance, leasing and factoring companies, investment and equity funds, insurance companies, pawn shops and other entities such as text and mobile phone banking.

These market participants engage in diverse credit intermediation activities that involve certain risks, including credit, counterparty or collateral risks, but do not as yet involve long, complex, opaque intermediation chains that create linkages between the banking and shadow sectors.
banking sectors. One of the primary risks from shadow banking in developing countries appears to be from finance companies feeding credit booms without thorough credit screening. For example, in Turkey, inappropriately regulated and aggressive commercial practices by finance companies offering quick loan approval via text message or automated teller machine\textsuperscript{6} nurtured an unsustainable credit boom in 2011, which had to be curbed by interventions of the central bank and regulators. Non-bank credit intermediation for corporates and financial institutions can take on many different and less predatory forms, but it relies on the same fragile funding model. Nonetheless, the financial markets of many developing countries are only partially integrated with global financial markets. As a consequence, shadow banking in developing countries poses risks that are more traditional and local than systemic.\textsuperscript{7}

As in the developed world, the share of shadow banking in credit intermediation varies by country. According to some estimates, shadow banking may represent between 35 per cent and 40 per cent of the financial sector in the Philippines or Thailand, but only about 20 per cent in Indonesia and Croatia, and only slightly above 10 per cent in China.\textsuperscript{9}

Achieving these goals presents a complex challenge for policymakers since there can be trade-offs between ensuring stability and providing necessary access to credit. However, finding an appropriate balance is imperative if the financial sector is to fulfill its role of allocating credit effectively for long-term sustainable growth.

### Progress in implementing Basel III

The agreed deadline for initiating implementation of Basel III is 1 January 2013. According to the Basel Committee, the adoption of the Basel III rules under national law was planned or under way in all 27 member jurisdictions of the Basel Committee in 2012, with some members facing significant challenges to meeting the deadline. The framework is also expected to be implemented to some extent in many non-member countries of the Basel Committee. Judging from past experience, implementing the framework within the agreed schedule indeed represents a challenge. As of 2012, the previous frameworks of Basel II and Basel II.5 (expected to come into force in end-2006 and end-2011, respectively) have not been implemented as yet by all Basel Committee Members.\textsuperscript{22} Moreover, some elements of Basel III will be fully phased in as late as 2018 or 2019.\textsuperscript{23} Monetary and financial supervision authorities might consider accelerating regulatory reforms, or at least ensuring that critical elements of the reform package can enter into force sooner.

Basel III reforms—which include higher and better quality capital requirements, liquidity buffers and leverage rules—are designed to impose higher costs on risky

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\textsuperscript{22} Basel Committee on Banking Supervision, “Report to G20 Leaders on Basel III implementation” (Bank for International Settlements, June 2012).

\textsuperscript{23} The capital conservation and countercyclical buffers will be gradually phased in from January 2016 to January 2019; the leverage ratio is intended to be implemented in January 2018, following a parallel run; the liquidity buffers will be implemented in January 2015 (30 day liquidity) and January 2018 (longer-term liquidity).
activities of banks to internalize the costs of risky behaviour, in an attempt to incentivize banks to reduce risky activities. As such, it should enhance the resilience of banks towards future shocks. Nonetheless, it has been suggested that the measures may not be sufficient to create a stable and well-capitalized financial system. Several studies have concluded that capital requirements should be significantly higher than those envisaged by Basel III. Indeed, several countries, notably some with outsized financial sectors such as Switzerland and the United Kingdom, have already phased in higher capital requirements for important banks in their jurisdictions. It is also argued that the leverage ratio had been met before the financial crisis by many banks that later faced distress.

There are also concerns that tighter bank regulations, in conjunction with the complexity of the Basel III framework, might trigger a new wave of regulatory arbitrage. It is reported that new products are already being created to circumvent the new rules (box III.3). In most countries the regulatory supervisory capacity is limited, making it difficult for regulators to keep pace with these kinds of developments. It is thus crucial to improve regulatory supervisory capacity through programmes geared towards education of regulators as well as more competitive compensation. Nonetheless, financial markets have been characterized by innovations and change, making it difficult for even well-trained supervisors to be able to effectively oversee a complex regulatory system. More generally, complex regulations can be difficult to administer and costly. This argues for broad-based simple regulations, such as high capital ratios and low leverage ratios, with simple countercyclical rules built in. Indeed, there are calls for greater regulatory simplicity and transparency as a way to enhance accountability, avoid regulatory loopholes and arbitrage, and facilitate implementation.

There are trade-offs between safety and allocation of credit to risky, albeit productive, activities. Basel rules, which have higher capital charges for riskier investments, could result in less lending to SMEs. The tighter capital and liquidity standards in Basel III could also reduce the availability of long-term financing, with a particularly negative impact on green investments, as well as on developing countries that have large infrastructure needs. Overall lending to some developing countries (particularly to those with sub-investment-grade credit ratings) is likely to be impacted, as the capital requirements under Basel III would imply higher borrowing costs and scarcity of credit in these markets. In particular, and despite amendments to the Basel III framework, there are continuing concerns over the implications of the new rules for trade finance (box III.2). Similarly, very safe financial systems might also tend not to be inclusive in terms of offering financial services to the poor.

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24 See World Economic Situation and Prospects 2012 (United Nations publication, Sales No. E.12. II.C.2).
27 It may still be appropriate to have some specific regulations in particular areas, but only when they are areas that are relatively self-contained and for which regulators have access to full information.
During the global financial crisis, large financial institutions, in particular, were found to have spread systemic risks. In response, G20 leaders agreed to strengthen the oversight and regulation of global systemically important financial institutions (G-SIFIs), focused on minimizing the adverse impacts their distress or failure might have on the financial sector as well as on the broader economy. In 2011, the FSB identified an initial group of 29 G-SIFIs, nine of which are headquartered in jurisdictions that have not yet fully implemented Basel II or II.5. A key element of the measures put forward by the FSB to address the phenomenon of “too big to fail” is that G-SIFIs should have a loss-absorbing capacity beyond the general standards of Basel III (that is, an additional capital requirement of between 1.0 per cent and 3.5 per cent, to be phased in by 2019), although it is not clear...
that this will be sufficient. A further concern is that the new regulations might exacerbate this concentration of the financial sector in a few big banks, since absorbing the higher costs may require economies of scale.30

The FSB has also recommended that G-SIFIs develop recovery and resolution plans (also known as living wills), and that countries prioritize this in national regulatory frameworks. Other related FSB recommendations include the establishment of crisis management groups for G-SIFIs, which would include regulators, supervisors, central banks, and other authorities, as well as cross-border cooperation. The FSB is currently developing standards for domestic regulators to follow in supervising G-SIFIs, and is working to extend the resolution planning framework to systemically important insurers and non-bank G-SIFIs.

Most countries have been slow to implement the FSB recommendations. There are some exceptions, however, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, which incorporates living wills into its framework. Altogether, the “too big to fail” problem remains largely unresolved. Measures to decrease financial concentration should be explored, including steps to reduce the size of financial conglomerates by separating different business lines and creating a more diversified banking system, with a greater role for cooperative and savings banks, for instance.

**Reforms in compensation and incentives**

Compensation practices encouraging excessive risk-taking were a key contributing factor to the global financial crisis. Many financial market participants are compensated on the basis of annual performance, which can incentivize excessive short-term risk-taking, without factoring in medium- or long-term risks. According to FSB surveys of market participants, more than 80 per cent of respondents believe that compensation packages contributed to the accumulation of risks that led to the crisis, with general agreement that without changes in such incentives, other reforms are likely to be less effective.31

The dominant view among policymakers as represented by the FSB is that “executive compensation is not simply a market wage, but an incentive system”.32 The implication is that because compensation structures and incentive structures have an effect on risk-taking within financial institutions, they should fall under the regulatory framework, whereas compensation levels, as such, need not. To this end, in 2009 the FSB defined “principles and guidelines for sound compensation”, aimed at curbing excessive risk-taking by financial institutions by improving the alignment of compensation with risk-taking, as well as the governance and supervision of compensation practices. Many countries have since taken steps to incorporate compensation structures into their supervisory frameworks, but in general it is not clear that these will be strong enough to fully alter incentives. In particular, the FSB rules define broad guidelines only and do not set clear parameters on how they should be implemented. For example, in the United States, banks with a global presence are required to identify employees whose incentive compensation can influence risk-taking and to incorporate features into their compensation packages that promote balanced risk-taking. The details vary, however, across jobs and businesses.

In 2012, JP Morgan Chase’s unexpected multibillion dollar loss in a group that was meant to be hedging the bank’s positions—not engaged in risk-taking—shows how difficult such identification and monitoring can be. Furthermore, the proposed measures apply to only the banking sector, and in particular to G-SIFIs, and do not address shadow banking, where risk-taking and compensation are highest.

**Global risks of shadow banking**

Another side effect of the new regulations is that risky activities that require higher capital might shift from the regulated banking system to shadow banking practices. The value of shadow banking assets rose from an estimated $26 trillion in 2002 to $62 trillion in 2007. Although shadow banking as a percentage of GDP declined after the crisis, assets in the shadow banking sector remain significant, at $67 trillion in 2011 (figure III.3), or 24 per cent of assets held by the global financial system (figure III.4). Shadow banking activities are particularly important in certain countries, such as the United States where the sector harbours assets worth around $23 trillion and represents 53 per cent of credit intermediation (down from 60 per cent in 2007).

Credit intermediation in the shadow banking sector is performed by a wide range of disparate entities with very different characteristics (box III.2) However, two common elements exist among them: they are not subject to the banking sector regulatory framework and, as such, they lack direct access to a liquidity backstop through a public lender of last resort (although central banks have provided shadow banking entities with

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liquidity in crisis situations with systemic implications, as was the case with money market funds in the United States, discussed below).  

As a result, shadow banking allows greater risk-taking than traditional banking, as well as opportunities for capital, tax and accounting arbitrage.

Both banking and non-banking credit intermediation involve risks, including leverage, maturity and liquidity mismatches, procyclicality, and lack of transparency. These risks become magnified in shadow banking entities, in large part because they are outside of the banking regulatory framework. In addition, many shadow banking entities have compensation schemes based on short-term performance that can lead to excessive risk-taking, as discussed earlier.

Leverage ratios in shadow banking entities are often much higher than in banks. Leverage ratios were close to 30 in many investment banks prior to the financial crisis. Some hedge fund strategies are based on leveraging more than 50 to 100 times the fund equity, and structured vehicles, or at least certain tranches, tend to be highly leveraged by design. Shadow banking entities, such as hedge funds, pose systemic risks through interlinkages with the banking system, such as leverage provided to hedge funds by regulated banks and counterparty risks from trading activities. In the absence of clear ring-fencing between banks and shadow banks, many leveraged shadow banking entities remain affiliated with banks or directly owned by them. While moving activities off banks’ balance sheets may be consistent with the regulatory framework, the build-up of leverage in shadow banking entities with linkages to banks jeopardizes financial stability. Although some regulation, like the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, attempts to limit these linkages, many of the measures that may have ensured a more solid ring-fencing were left out or diluted in the final agreement.

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35 Ibid.
Shadow banking’s excessive reliance on short-term and secured funding heightens systemic risk

In addition, many shadow banking entities use short-term wholesale funding to finance long-term and illiquid assets, such as borrowing from money market funds or by issuing short-term securities, which entail greater refinancing risks than traditional deposits. At the same time, shadow banking entities generally lack official access to a lender of last resort, and are also outside government deposit insurance programmes, making them more vulnerable to bank runs. For example, money market funds (MMFs) in the United States experienced such a run during the crisis. MMFs hold short-term securities, and pass the interest on to their investors. Consumers and investors often use these funds as alternatives to bank accounts, and do not expect to lose their principal investment. However, during the crisis, the value of the short-term securities held by the funds fell, so that the net asset value of at least one MMF fell below 100 per cent. Within two days of the announcement of “breaking the buck”, investors had withdrawn approximately $200 billion or 10 per cent of assets from the MMF market. The redemptions contributed to a freezing of the United States commercial paper market, so that top-rated United States firms were unable to refinance working capital loans, and to a spike in short-term United States interest rates. Ultimately, the Government provided a guarantee and liquidity backstop to stop the run.

Most shadow banking entities are also subject to mark-to-market accounting, which amplifies procyclicality, especially in combination with secured (or collateralized) financing. When asset values fall, additional collateral must be posted, which can force entities into sell positions in order to meet collateral calls, further depressing asset prices. This amplifies deleveraging during crises and, conversely, money creation in good times, potentially weakening the countercyclical effectiveness of monetary policy.

These risks are compounded by the lack of transparency in many shadow banking activities. Hedge funds are notoriously secretive about their strategies and positions, and many structured products are opaque. For example, prior to the crisis, banks provided guarantees to off-balance-sheet structured investment vehicles (SIVs). In the event of defaults above a specified threshold on the underlying loans, the SIVs would transfer the non-performing loans to the bank’s balance sheet. These guarantees, which were generally hidden from both regulators and shareholders, substantially increased the riskiness of the banks.

In addition, many shadow banking entities are extremely complex and difficult to understand, leading to systemic mispricing of securities, which can amplify boom and bust cycles. This was particularly evident prior to the crisis with respect to securitization and structured products, especially those that securitized sub-prime mortgages. Although the sub-prime mortgage market was introduced in the United States in the 1980s, it did not become sizeable until the late 1990s, growing from 83,000 mortgages in 1995 to more than 1,600,000 in 2006. As such, there were only limited data on how these mortgages

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37 Whereas deposits in banks are guaranteed by official insurance funds, such as the Federal Insurance Deposit Corporation (FDIC) in the United States, shadow banking at best relies on private guarantees, which often become unreliable in difficult times.

38 The direct extension of public guarantees to several shadow banking entities and markets contributed to restoring some financial stability, but it also opened a debate about the legality and legitimacy of using public funds to assist parts of the financial sector that were not entitled to such assistance as well as shortcomings of existing governance mechanisms. See Levy Economics Institute of Bard College, “Improving governance of the government safety net in financial crisis”, April 2012, available from http://www.levyinstitute.org/pubs/rrp_gov_12_04.pdf.

would perform in a severe economic slowdown. Given the limited historical data, rating agencies used dubious assumptions about default rates and correlations that were plugged into models designed to be overoptimistic. As a result, risks were systematically ignored and not captured in available data. Ultimately, investors’ blind reliance on ratings led many in the financial community to trade products they did not understand. While securitized products can have benefits for lending, especially to underserved groups (box III.3 above), it is crucial that they be effectively regulated in order to identify and reduce systemic risks.

Progress in regulating shadow banking

The build-up of systemic risk that occurred in shadow banking entities in the run-up to the crisis highlights the need for a new approach to financial sector regulation—one that encompasses monitoring and regulation of all mechanisms that intermediate credit. Most efforts to reform shadow banking are being coordinated at the international level, but progress has been slower than expected. At the November 2010 Seoul Summit, in view of the completion of the agreement on new capital standards for banks in Basel III, the G20 leaders requested that the FSB, in collaboration with other international standard-setting bodies, develop recommendations to strengthen the oversight and regulation of the shadow banking system by mid-2011.  

In October 2011, the FSB proposed an overall approach and formulated some general principles and recommendations, focused on banks’ interactions with shadow banking entities, MMFs, other shadow banking entities, securitization, and securities lending and repos. The proposed approach and possible regulatory measures were further refined and open for public consultation in November 2012. Those measures include imposing concentration and exposure limits as well as stricter consolidation rules to limit the vulnerability of banks to risks in the shadow banking sector, and to ensure that bank guarantees are included on bank balance sheets. In the case of MMFs, the rules being considered would require that MMFs move from constant to variable net asset value accounting and accept the imposition of bank-like capital buffers. Proposed measures to reduce risks in relation to securitization include improving information disclosure and imposing retention requirements, which require banks to maintain a portion of the security on their balance sheet in order to increase their stake in credit evaluation and monitoring of the portfolios. Proposed rules to temper the procyclicality of collateralized lending include providing better guidelines on collateral management, valuation and reuse. Finally, the role of credit rating agencies should be reduced and the transparency and reporting of information continually improved.

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To reduce risks in the derivatives market, the G20 has also agreed that OTC derivatives that can be standardized should be traded on formal exchanges or electronic platforms by the end of 2012. The United States, the EU and Japan have made progress in implementing these reforms and are expected to have them fully implemented by the end of 2012. The regulation and transparency of the over-the-counter derivatives market should be improved through requirements for the reporting and central clearing of transactions. Despite slow implementation, it is expected that the progress in terms of infrastructure and legislation will allow at least the jurisdictions with the largest markets in over-the-counter derivatives to comply with the deadline.44

At the domestic level, initiatives have been taken in some countries to improve regulation in a limited number of areas.45 Information disclosure standards in debt securitization, for instance, have been strengthened in several countries. However, recent setbacks of regulatory proposals in the United States and slow progress in other developed countries cast doubt over the possibility of reaching an international consensus that would significantly reform and contain systemic risk generated in shadow banking. The continued existence of opportunities for capital, tax and accounting arbitrage, and the exclusion of shadow banking from the debate on perverse compensation incentives and excessive risk-taking, further hinder the possibility of decisively tackling systemic risks generated by shadow banking.

At the global level, it is crucial to ensure that the implementation of regulations is internationally coordinated and consistent. Although a regulatory framework needs to ultimately be designed for the needs of the domestic economy, which can differ across countries, regulatory arbitrage needs to be limited so that high-risk activities will not be merely shifted from more to less strictly regulated sectors or jurisdictions. The establishment of frameworks for monitoring implementation by the FSB and the Basel Committee for Banking Supervision, which involve peer reviews, is a step in the right direction in this regard. Nonetheless, the complexity of the proposed regulations could present new costs. Ultimately, a simple, comprehensive regulatory structure might be more efficient.

Other international financial stability issues

Global financial safety net

The multilateral capacity to provide liquidity represents a crucial factor in safeguarding global financial stability. A reliable global financial safety net would also reduce the incentive for countries to accumulate reserves in order to cope with adverse shocks. In the wake of the financial crisis, steps have been taken to strengthen the global financial safety net.

In 2012, resources available to the IMF for crisis prevention and resolution were significantly reinforced. A number of countries committed themselves to provide an additional $461 billion for this purpose, almost doubling the Fund’s lending capacity. These resources will be in addition to quota increases under the IMF 2010 quota review and previously enhanced borrowing arrangements of the Fund with member countries.

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and central banks. The IMF also continued to reform its liquidity and emergency lending facilities. In 2011, the Precautionary Credit Line was replaced by the Precautionary and Liquidity Line, which is designed to more flexibly meet the liquidity needs of member countries with sound economic fundamentals. In addition, the Fund’s instruments for emergency assistance were consolidated under the new Rapid Financing Instrument, which may be used to support a range of urgent balance-of-payments needs.

Altogether, the international financial safety net has continued to evolve towards a multilayered structure comprising global, regional and bilateral components. The overall size of the collective safety net, however, remains small in comparison to reserves accumulated by national central banks. Moreover, there continues to be a lack of a global mechanism ensuring the swift and sufficient availability of substantial resources to stabilize market conditions in times of systemic liquidity crises. Efforts to further strengthen crisis-lending facilities should therefore focus on enhancing the different layers of the financial safety net as well as strengthening the coordination and consistency between the mechanisms at different levels.

The G20 Principles for Cooperation between the IMF and Regional Financing Arrangements, endorsed at the Cannes Summit, recognized that enhanced cooperation between IMF and regional financial arrangements would be a step towards better crisis prevention and resolution. The financial and operational capacity of mechanisms in some regions has been reinforced, as in Europe or in East Asia. In the euro area, the European Stability Mechanism was introduced, which provides rescue funds of €500 billion (about $628 billion). In May 2012, the members of the Association of Southeast Asian Nations plus China, Japan and the Republic of Korea under the Chiang Mai Initiative agreed to double the size of their emergency liquidity programme to $240 billion and make it more readily available. In Latin America, the Inter-American Development Bank and the Andean Development Bank are playing increasingly important roles, but these act as development banks rather than as monetary funds. In Africa, there is no appropriate institution that can step in to provide regional liquidity.

In terms of the relative size of the different components of the global financial safety net, it is important to note that the bulk of liquidity needed to ease funding pressures has been provided by key central banks. For instance, the volume of Long-Term Refinancing Operations offered by the European Central Bank in late 2011 and early 2012 alone amounted to over €1 trillion. The involvement of major central banks will therefore remain pivotal for a functioning and sufficient global financial safety net. The creation of a more permanent framework of liquidity lines between key central banks should be given consideration. The existence of such agreements, even in times of limited usage, is considered to have a stabilizing effect on markets.

**Multilateral and financial sector surveillance**

Surveillance of the global economy for early warnings on economic and financial risks is another key element in taming the boom-bust cycles of international finance. In the run-up to the global crisis, the build-up of such risks was not properly captured by IMF

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surveillance. In particular, shortcomings in the surveillance approach were identified with regard to cross-border and cross-sectoral linkages. The ability to assess the impact of policies and shocks in major economies on other countries and regions and determine the linkages between the financial sector and the real economy are central to effective surveillance. Efforts of the IMF have continued to strengthen the capacity of multilateral surveillance to identify risks to global financial and economic stability in a timely and comprehensive manner. It has also taken a number of steps to strengthen the quality and coverage of its surveillance activities.

In 2011, the Fund prepared its first spillover reports for the world’s five largest economies (China, Japan, the United Kingdom, the United States, and the euro area) to better reflect interconnections between the world’s economies. The reports assessed the impact of policies in those economies on partner economies and stressed the importance of financial channels for transmitting global shocks. Implementing the recommendations of its 2011 Triennial Surveillance Review and the related Managing Director’s Action Plan, the Fund has furthermore continued to reform and broaden its surveillance approach, through better integration of bilateral and multilateral surveillance, for instance. The monitoring of global stability risks emanating from financial sectors has been strengthened by the decision to make financial stability assessments at five-year intervals a mandatory part of surveillance for the 25 jurisdictions with systemically important financial sectors. Under the revamped IMF/World Bank Financial Sector Assessment Programme, several systemically important financial sectors have been assessed in 2012. Furthermore, a new IMF Financial Surveillance Strategy was adopted in September 2012, which aims to strengthen the analytical underpinnings of risk assessments and policy advice, upgrade the instruments and products of financial surveillance, and engage more actively with stakeholders in order to improve the traction and impact of financial surveillance.

International development cooperation and official flows

Official development assistance

International public financing represents a form of global collective action for financing of global social, economic and environmental goals, which are often not financed by the private sector. In addition, official financing can be used to leverage private finance in areas that promote social goals, such as climate financing. However, similar to private finance, official financing to countries has been subject to instability and unpredictability. After reaching a peak in 2010, ODA from member countries of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) fell 2.7 per cent in real terms to $25 billion in 2011, equivalent to 0.31 of gross national income (GNI) of DAC members. This represents the first significant fall in ODA, excluding years of exceptional debt relief, since 1997 (figure III.5). Net ODA fell in 16 countries, including the largest donors, such as the United States and the EU countries, which reduced their shares of ODA in GNI from 0.21 per cent to 0.20 per cent and from 0.44 per cent to 0.42 per cent, respectively. Steep declines were observed in Greece and Spain (more than 33 per cent) and Austria, Belgium and Japan (more than 10 per cent). Moreover, expected tight aid budgets in DAC member countries are expected in the coming years.
Bilateral ODA to the least developed countries (LDCs) fell by about 2.0 per cent in real terms in 2011, even though donors renewed their commitment to provide at least 0.15 per cent of their GNI as aid to LDCs by 2015 at the Fourth United Nations Conference on the Least Developed Countries (LDC IV) in May 2011. The Programme of Action for the Least Developed Countries for the Decade 2011-2020 set a target that at least half of the LDCs should be eligible for graduation from the category by 2020.

The fall in ODA widens the gap on aid delivery between global aid and the 0.7 per cent agreed United Nations target by $4 billion, from 0.38 per cent of donor GNI in 2010 to 0.39 per cent. Total ODA would have to more than double to about $300 billion in 2011 dollars to reach the target.48 As of 2011, only Denmark, Luxembourg, the Netherlands, Norway and Sweden exceeded the United Nations ODA target. More recently, however, the Netherlands announced plans to cut its aid budget by €1 billion by 2017, which will bring its contribution well below 0.7 per cent.

Declining ODA thus endangers the prospect of achieving the international targets adopted by donors at major international fora49 during the past decade. This was already apparent in 2010 in the failure to reach the G20 Gleneagles summit pledge of reaching 0.36 percent level of the combined GNI of the DAC members, which was, in turn, regarded as an intermediate objective toward meeting the long-standing United Nations ODA target of 0.7 per cent. In addition, the commitment made in Gleneagles to increase aid to Africa by $25 billion in 2010 was not met either.

An OECD Development Centre Study, published in April 2012,50 estimates a $120 billion additional resources gap to achieving the MDGs, while the current flows of

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49 Including the Monterrey (2002) and Doha (2008) conferences on financing for development, the Millennium Development Goals (MDG) and the Fourth United Nations Conference on the Least Developed Countries in Istanbul (2011), in particular, the G20 Gleneagles summit pledges.
country-programmable aid from OECD countries stand at roughly half this figure. More than half of it is needed in 20 low-income countries with per capita income lower than $1,000 and, in the absence of expeditious action, about 35 countries will fall short of the goal of halving the number of people living in absolute poverty. Urgent action is required for these pledges to regain credibility and the necessary political traction.

Following the shortfall in the EU target for ODA delivery, the Foreign Affairs Council of the European Union took a decision on the proposed “Agenda for Change” by the EU Commission, in which it reaffirmed its commitment to achieve all their development aid targets—including the collective 0.7 per cent ODA to GNI target—by 2015. 51 Furthermore, the Council reiterated its commitment to policy coherence for development and identified key strategic priorities. The Council’s focus is on governance and inclusive sustainable growth as the two over-arching pillars of development cooperation, and it will follow a more differentiated approach to countries at varying levels of development and concentrate on a maximum of three sectors per country. The mix and level of aid would be adapted according to needs, capacity and impact, as well as the progress made in commitments to—and the record on—human rights, democracy and rule of law, reforms implementation and meeting the needs of the people.

Before the Council approved the “Agenda for Change”, the April 2012 DAC Review of the Development Cooperation Policies and Programmes of the European Union noted that more progress was needed. The Review made a number of recommendations, 52 including strengthening its differentiated international cooperation strategy with appropriate funding within the 2014-2020 financial framework, simplifying its complex budgetary and administrative processes, while aligning with member country policies and devolving more authority to its staff in the field.

Recently, the European Parliament development committee adopted a set of amendments that will be the basis of the negotiations with the Council on the new Development Cooperation Instrument regulation that will come into effect when the current one expires (after December 2013). The September 2012 proposed amendments 53 include a renewed focus on inequality, since the proposed Agenda for Change selection implied that middle-income countries would lose EU bilateral aid, based mostly on per capita income. Other important aspects are the call for a smoother transition when phasing out aid, more democratic oversight, and making climate change-related aid additional to the 0.7 per cent contribution that member states have to provide as ODA.

DAC members approved a Recommendation on Good Pledging Practice to ensure credible and feasible pledges with enhanced accountability and transparency in 2011. Now, donor countries, who are in a position to do so, need to set progressive quantitative aid targets based on recipients’ needs assessments. Furthermore, LDCs need more access to highly concessional funds and grants if they are to meet their essential spending needs and also respond in a countercyclical way to the global economic crisis without falling back into debt distress. This is particularly true for those LDCs facing fragile situations resulting from institutions being weakened by the risk that their share of ODA allocation will be lowered based on performance.

51 Council of the European Union, “Council conclusions: increasing the impact of EU development policy—an agenda for change”, issued at the 3166th Foreign Affairs Council meeting in Brussels, 14 May 2012.


There is also evidence that along with the drop in ODA, the profile of ODA has shifted, particularly for low-income country recipients. As shown in figure III.6, budget support has fallen and project support has grown, along with the decline in aid. This could be indicative of an effort by donors to make aid allocation more results orientated, believing that this increases aid efficiency. “Measurable outputs” are important from the donors’ perspective, as programmes that have a clear results focus tend to more readily receive parliamentary approval in donor countries. Nonetheless, the explosion in the number of individual aid projects by multiple donors has been widely criticized for not only exacerbating the fragmentation of aid architecture, but also imposing high transaction costs on recipient governments with scarce resources, failing to align with countries’ national priorities and development strategies, and undermining country ownership—which is at the core of the Paris Principles of Aid Effectiveness. Recognition that the role of aid lies in encouraging and supplementing national resource mobilization to meet national development goals, including the MDGs, has led to calls for aid to be increasingly used for budget support.

As a whole, the objectives of the 2005 Paris Declaration on Aid Effectiveness set for 2010 have not been fully implemented, with only one out of 13 targets met. Establishing mutual accountability mechanisms has been the indicator with the least progress so far. While recipients have, in general, complied with this framework, donors have not.54 As recognized in the Accra Agenda of Action, aid distribution across countries remains insufficiently coordinated and the problem of aid “darlings” and “orphans”, as well as “herding” behaviour by donors persists, with donor self-interest and geopolitical factors often outweighing recipients’ needs and their ability to use aid effectively.

Although the proportion of official aid in total financing flows to developing countries is diminishing, ODA remains critical for many countries. Many countries are in need of increased assistance to meet emerging additional challenges such as climate change and food price increases. The Global Partnership for Effective Development was launched

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54 Ibid.
at the Fourth High Level Forum on Aid Effectiveness in Busan, Korea in November-December 2011. The principles of the Global Partnership for inclusive development need to be translated into balanced, effective arrangements benefitting all.

There is scope to further improve collaboration and coordination among donors and between donor and recipients at both global and national levels. Together with fostering the Global Partnership, the Development Cooperation Forum of the United Nations Economic and Social Council could be strengthened to ensure that the concept of aid effectiveness—broadened to capture all aspects of development effectiveness—goes beyond strengthening country ownership by aligning ODA with recipient country’s development strategies and plans, and increasing the use of their own systems for procurement and financial management.

### South-South cooperation

The dynamism of South-South trade and financing is part of the explanation for the relative resilience of developing countries in the recent crisis. The estimated volume of South-South cooperation financial flows was calculated to have reached 20 billion in 2010, and is expected to grow further. However, the full size of South-South cooperation is not known, as many of the transactions are not fully reported. The knowledge gaps in South-South cooperation need to be acknowledged and addressed by creating proper reporting procedures that can solve the problem of fragmented and incomplete data.

Most of the resources in South-South flows are in the form of bilateral programmes of project funding. Unlike traditional aid, South-South cooperation tends to use a multi-pronged development strategy, incorporating trade and investment along with aid to support necessary infrastructure for the broader investment, generally without conditionalities. South-South cooperation also extends to areas of knowledge-sharing, as a tool for facilitating capacity development and innovation. Much South-South cooperation, particularly from China, appears to be market driven (using market interest rates) in the area of natural resources, with much of the lending collateralized. As such, it is not an alternative to existing aid.

The Busan outcome document acknowledged the difference between South-South cooperation and North-South cooperation in terms of nature, modalities and responsibilities. At Busan, countries agreed to form an integral part of a new and more inclusive development agenda, in which actors participate on the basis of common goals, shared principles and differential commitments. South-South cooperation can work in concert with traditional forms of development aid which, in recent years, have tended to focus more on humanitarian and social interventions, and increasingly, on climate adaptation and mitigation. The complementarity of South-South flows, traditional ODA, and other flows should be integrated to enhance the overall development architecture.

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56 See United Nations, General Assembly, “Report of the Secretary-General on the state of South-South cooperation” (A/66/229), para. 15.


58 See “Busan Partnership for Effective Development Cooperation”, Outcome document at the Fourth High Level Forum on Aid Effectiveness held in Busan, Republic Of Korea from 29 November-1 December 2011, paras. 2 and 14.

Innovative sources of international financing for development

Nonetheless, shortfalls in traditional ODA and the need for additional and more predictable international public financing has led to a search for new funding sources in addition to South-South cooperation and other flows—not as a substitute for aid, but as a complement to it. The G20 at the Cannes Summit on 4 November 2011 acknowledged the need to tap new sources of funds for development and global public goods. The outcome document of the United Nations Conference on Sustainable Development (Rio+20), entitled “The future we want”, also states: “We consider that innovative financing mechanisms can make a positive contribution in assisting developing countries to mobilize additional resources ... (s)uch financing should supplement and not be a substitute for traditional sources of financing.”

Estimating the amounts raised through innovative financing mechanisms is a true challenge. There is no internationally agreed definition of innovative financing and as a consequence there are no standardized reporting systems to monitor these flows. As a result, estimates differ according to the mechanisms and sectors deemed as innovative financing. Classification schemes such as those by the OECD and the World Bank differ in their coverage, and so their estimates are not strictly comparable. The 2011 Report of the Secretary-General on Innovative mechanisms of financing for development estimated that funds raised through innovative financing mechanisms for the period 2002-2011 ranged between $37 billion and $60 billion.

A recent comprehensive study by the United Nations estimates that when restricting the concept of innovative financing for development to include only mechanisms involving public sector involvement linked to international development cooperation, about $8.4 billion in resources are being channelled through innovative financing mechanisms, at best, with only a few hundred million dollars in new, additional funding raised annually.

The innovative initiatives that have been launched during the past decade, such as the solidarity levy on airline tickets, Norway’s tax on CO₂ emission from aviation fuel, the Affordable Medicines Facility - malaria, the International Finance Facility for Immunisation (IFFIm), and Debt2Health, share of proceeds from issuing new certified emissions reduction units (CERs) have in large part been used to fund global health programmes and to finance climate change mitigation and adaptation. While these initiatives have successfully provided immunizations and AIDS and tuberculosis treatments to millions of people in the developing world, they have not yielded significant additional funding on top of traditional development assistance. Most of the new mechanisms are not designed to raise additional resources. Instead, they are designed to restructure existing ODA to better match sources with needs. For example, the IFFIm brings forward future ODA for present expenditure, without providing a net increase in funds. Initiatives such as the GAVI Alliance, are designed to disburse financing.

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61. The report concluded that in order to correctly record the scale of revenues raised, an international agreement is needed on the precise definition and scope of the term. Such an agreed definition would then provide the appropriate reference point for standardized reporting and accounting frameworks, which can be set up for recording reliable and coherent data over time.
62. See World Economic and Social Survey 2012: In Search of New Development Finance (United Nations publication, Sales No. E.12.II.C.1).
63. World Economic and Social Survey 2012, op. cit.
As discussed in the *World Economic and Social Survey 2012*, concentrating external resources on particular diseases may skew health sector policies away from national health priorities. There is a risk that the global focus on communicable diseases does not coincide with national concerns about other diseases, the development of effective and equitable health systems, and efforts to deal with broader determinants of health (such as food security, nutrition and diet, water and sanitation, and living and working environments). The Leading Group Task Force on Innovative Financing for Health recommended following aid effectiveness principles of country ownership in identifying health priorities within comprehensive national health strategies and plans, as well as investigating on possibilities to support comprehensive national health strategies and plans through resources raised by innovative financing mechanisms, channelled through country systems where the conditions are in place.

The Finnish Presidency of the Leading Group on Innovative Financing for Development announced in September 2012 that it is planning to work on clarifying and seeking common understanding of the concept of innovative financing mechanisms and its relationship to official development assistance, as part of the financing for development agenda. An internationally agreed definition will be an important step towards a consistent reporting system that will deliver reliable data on the volume and scale of innovative finance. An agreed definition will also be key in future evaluations of the total volume of resources for development in terms of judging whether new funds are in fact additional to existing ODA, and determining the contribution and effectiveness of innovative financing to meet development objectives.

Innovative mechanisms with larger fundraising potential include international taxes on financial transactions and on carbon emissions, and the use of IMF’s Special Drawing Rights (SDRs). Around $400 billion to $450 billion per year could be raised through a combination of mechanisms. For instance, the *World Economic and Social Survey 2012* estimates that a tiny tax of 0.005 per cent on major currency foreign-exchange transactions (dollar, euro, yen and sterling) would generate $40 billion in additional development resources annually, while broader taxes on financial transactions such as trades, bonds and derivatives could yield between $15 billion and $75 billion. The proposed EU financial transaction tax is estimated to raise $75 billion per year, although little, if any, would be for development purposes. A tax of $25 per ton of CO$_2$ emissions by developed countries could raise $250 billion in revenues for international climate financing. Proposals for annual issuance of additional SDRs and/or leveraging idle SDRs could yield at least $100 billion (Box III.4).

Each of these options is technically feasible and economically sensible. Realizing their potential, however, will require international agreement and political will. As with existing mechanisms, efforts are needed to ensure that resources raised through new mechanisms are stable, aligned to recipient countries’ development strategies, and that delivery is consistent with recipient countries’ priorities and systems.

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64 World Economic and Social Survey 2012, op. cit.


One potential innovative source of development finance is through the Special Drawing Rights (SDRs) of the IMF. It is important to separate the possible development financing functions of SDRs allocated to developed countries from their role in increasing the reserves of developing countries. There are two types of proposals for using SDRs for development purposes, as presented in the World Economic and Social Survey 2012. The first is based on new annual issues, with the SDR allocations favouring developing countries. The proposed additional collective insurance would reduce the need for developing countries to accumulate reserves from their own resources, thus potentially freeing up space for enhanced developmental investments. Note that while this mechanism should help increase global stability, it only indirectly contributes to enhancing existing pools of development finance.

The second proposal leverages developed country allocations for development financing by floating bonds backed by SDRs, rather than by spending the SDRs directly. This more direct channel would leverage the “idle” SDR allocations held by developed and emerging economies with abundant official reserves. Idle SDRs jumped from approximately SDR13 billion to almost SDR200 billion ($320 billion) after the issuance of SDR250 billion in 2009 (figure). Using a conservative estimate, around $150 billion of existing idle reserves could be utilized to purchase bonds. If combined with new allocations of between 150 billion and 250 billion in SDRs every year, amounts in that order may be usable for financing long-term development on an annual basis.

An alternative would be to create “trust funds” to leverage SDRs. In this proposal, $100 billion in “SDR equity” could be used to back issuance of $1 trillion in bonds, using a leverage ratio of 10 to 1. Assuming a 10-year maturity, this would provide $100 billion for development financing per year. This could, for instance, meet the initially agreed needs for climate financing for the Green Climate Fund. A high leverage ratio, however, exposes bond holders to greater risk, thus raising the cost of borrowing. An additional argument against the use of such leverage is that it breaches the original purpose of SDRs, which were created solely for transactions of a purely monetary nature. Leveraging SDRs in such a way as to expose their holders to risks of illiquidity distorts the purpose for which they were created. The viability of the proposal thus depends on how much risk would be involved, and on designing the financial instrument for leveraging SDRs carefully enough to maintain its function as a reserve mechanism. The risks are further limited to the extent that the proposal is restricted to using idle SDRs, which is similar to the existing practice by a fair number of countries of moving excess foreign currency reserves into sovereign wealth funds. These proposals are technically feasible, but international agreements and political will are necessary.
Debt relief and sustainability

The current debt situation in developing countries does not pose a systemic problem, although vulnerabilities remain in some regions and countries, particularly the Caribbean, where two countries (Grenada and Haiti) were classified as in high risk of debt distress, and four (Dominica, Guyana, St. Lucia and St. Vincent and the Grenadines) were in moderate risk of debt distress as of 9 August 2012. Six countries which had received irrevocable debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative are still in high risk of debt distress, and there is a risk that continued global weakness will worsen debt sustainability in additional countries. As HIPC and multilateral debt relief initiatives are coming to a close, a new international framework for addressing future sovereign debt crises needs to be on the policy agenda.

Gaps in the financial architecture for debt restructuring were manifested in earlier sovereign debt crises in emerging markets and developing countries. For debtors, solutions have often been accompanied by undue lags and, for the most part, have provided too little relief, often leading to future debt restructurings, jeopardizing the resumption of growth and prospects for keeping debt sustainable. Concerns remain that efforts to reform the architecture have been insufficient and inadequate.

The euro area sovereign debt crisis has brought many of these issues to the fore even more forcefully. The rescue packages by the official sector, including the IMF, are unprecedented in history, putting considerable strains on the balance sheets of the public sector. The incremental policy response has yet to ensure a definite and timely end for the crisis, endangering the global economic recovery and the stability of the global financial sector. Moreover, there are concerns that such actions may also generate moral hazard. In debt restructurings this has been shown to lead to sovereign debtors deferring adjustments, to international lenders inadequately pricing risk, and to negotiations leading to lower debt write-offs, thereby postponing rather than solving the underlying problems of the sovereign debtor.

Given these and related issues, it is time to consider alternatives to ad hoc resolutions to sovereign debt crises. There are several options going forward with proposals ranging from those under the voluntary and contractual approach, such as ex ante structures and frameworks for creditor committees, to a statutory approach, or in-between solutions such as the setting up of a Sovereign Debt Forum, which would be a neutral organization with broad participation from debtors, private creditors and multilateral institutions. The lack of a mechanism to restructure sovereign debt in a fair and efficient manner contributes to global risks, threatening financing for development and adding to pressures on countries to build reserves, and thereby contributing to global imbalances.

Financing for long-term sustainable global development

In summary, the international financial system continues to be plagued by volatility and incentives to short-term behaviour. Volatile capital flows may result in higher volatility of

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69 IMF, “List of LIC DSAs for PGRT-Eligible Countries, as of 9 August 2012.”
consumption and boom and bust cycles, and the associated uncertainty may reduce investment and economic growth. In addition, capital account volatility has led to reserve accumulation as a form of self-insurance, exacerbating global imbalances, and holding back resources for long-term development investment. The lack of coordination of monetary policies among developed countries compounds this problem, as evident from continued stop-and-go capital flows to emerging markets, which also has the effect of weakening monetary policy responses in developed countries.

Proposals and reforms to financial regulation have been insufficient to address the problems of volatility and short-termism, including insufficient attention to incentives for excessive risk-taking in the banking and the shadow banking systems. Existing proposals and reforms have been mostly focused on the safety and stability of the banking system, with some attention to risks in the shadow banking system and risks associated with G-SIFIs (although these have been insufficient).

While a focus on stability is important, the ultimate goal of the global financial system should be to effectively allocate finance to long-term sustainable development in a stable manner. In particular, reforms to banking regulation need to take into account any impact they may have on growth and access to credit, as well as on stability. This is particularly important in developing countries, where access to credit for productive investment may be more limited. Policymakers in developing countries can choose to implement elements of Basel III and other regulations that best suit their needs, rather than necessarily implementing the full package. For example, it might make sense to integrate several of the ideas underlying Basel III—such as countercyclical buffers, liquidity ratios, increase in the quantity and, especially, the quality of core capital, adapted to local circumstances—into national regulatory frameworks. 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.

Reforms to the international financial system need to emphasize both stability and effective allocation of credit for sustainable growth. To that end, reducing global risks through a mechanism for resolving sovereign debt and strengthening the global safety net are also key. 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 sustainable financing for development.