Report
Workshop on Debt, Finance and Emerging Issues in Financial Integration

Commonwealth Secretariat 6 and 7 March 2007

Background

The Financing for Development Office organized a Workshop on "Debt, Finance and Emerging Issues in Financial Integration"[1] in partnership with the Common Wealth Business Council and Common Wealth Secretariat in London on 6 and 7 March in accordance with the United Nations General Assembly resolution 60/188 requesting the Financing for Development Office to continue to organize workshops, multi-stakeholder consultations and panel discussions to examine issues related to the mobilization of resources for financing development and poverty eradication. The report feeds into the discussions for the High-level Dialogue on Financing for Development in 2007 and the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus to be held in Doha in the second half of 2008.

I Emerging global Issues in financial Integration[2]

Global Imbalances

Amongst the new risks in the global economy are the high current account deficits in the US economy and large current account surpluses in Asia. There is heightened concern as historically adjustments in US external deficits have had a contractionary impact on the global economy and US output. It is clear that international policy coordination is needed to avoid abrupt adjustments – the risk of a large fall of the dollar accompanied by falls in the prices of bonds and equities.

The speaker Mr. Das pointed out that the existing large global imbalances cannot be sustained forever. On the one hand, there has been massive accumulation of foreign

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[1] The participants comprised practitioners and experts from the multilateral organizations (including UN DESA, Commonwealth Secretariat, IMF, and UNCTAD) senior government representatives (including ministers and governors of central banks), the private sector, civil society and academia. Background material and presentations can be found on the events section of the Financing for Development office website: http://www.un.org/esa/ffd. A list of participants and speakers is attached.

[2] The speakers in this session were: Mr Arnab Das, Global Head of Emerging Market Strategy, Dresdner Kleinwort; Professor Charles Wyplosz, Graduate Institute of International Studies, Geneva; and, Mr David Lubin, Managing Director, Citigroup Global Markets, London. The discussants, Mr Christoph Lindemann, Economist, Deutsche Bundesbank, Frankfurt and Mr Arnab Das, Global Head of Emerging Market Strategy, Dresdner Kleinwort.

exchange reserves, especially in East Asia, but also in countries as diverse as Russia, Saudi Arabia and India. This accumulation of reserves also reflect huge swings in the balance of payments current account positions of a number of developing economies, from deficits into large surpluses. At the same time, the fiscal accounts of a number of emerging economies have also turned around, with the notable exception of the EU periphery countries and South Africa, to register primary surpluses[3]. The flip side of all this, on the other hand, are the large twin deficits of the United States. To make matters worse, Mr. Das pointed out that monetary policies in the G7 countries are not synchronized and there also risks emanating from the high-leverage carry trades where investors have borrowed the low-yielding yen to purchase higher return currencies. He warned that the recent global market instability during the past few weeks could be a run up what Paul Krugman has termed a 'Coyote moment' whereby the imbalances unravel in a manner that destabilizes the global economy. While acknowledging that the rate of return to capital in countries such as Japan is still not high enough to lead to a large flight of capital back to the country, away from the dollar assets, he warned that market expectations could be driving a factor and these sometimes only fully kick-in once a crisis has actually begun.

The build-up of international reserves

In recent years the build-up of reserves has been a subject of concern and debate at the country level and international fora. Professor Wyploz in his paper, **"**The Foreign Exchange Reserves Buildup: Business As Usual?" assessed whether the large build-up of reserves in a number of developing economies has been truly exceptional and excessive and explored the reasons for the build-up. Many believe it to be an expression of mercantilist policies by some countries and others regard it as a tool of crisis prevention. The former view is informed by the evidence that the stock of reserves has considerably risen whether measured in nominal terms or as a ratio to GDP or exports. When scaled against GDP and trade, the increase in reserves is less dramatic but still shows a clear upward trend. This evidence according to Professor Wyploz can be deceptive. His paper gives evidence that when the stock of reserve is related to foreign liabilities, with few notable exceptions, there is just no evidence of a reserve buildup. In his view the level of reserves is a reflection of financial integration.

Moreover, since the crises of the 1990s, there has been a shift in risk-management policy in many countries from keeping reserves valued at three months of imports towards the Greenspan-Guidatti-Fischer rule that proposes reserves to be as big as short-term external liabilities. Professor Wyploz however showed that this upward trend is far less significant when reserves are measured as a ratio of external liabilities, since the latter have also been growing at a rapid pace (especially in South East Asia and the oil exporting countries). Given this, he argues that there is little evidence of excessive reserve accumulation, except in China and Republic of Korea which have accumulated reserves at a greater pace than external liabilities. Which is the correct measure depends in fact on

[3] According to Das, the fact that emerging Europe has not been affected to the same degree by the last round of crises in emerging markets in the 1990s may explain why they have made less efforts to 'insure' themselves by strengthening their internal and external accounts.

the motive for holding reserves. Looking at the ratio to GDP is justified if mercantilism is the driving motivation. Looking at trade and external liabilities is preferable if reserves are held for self-insurance. In addition, as countries become financially integrated, the correct ratio is to external liabilities since the main risk of currency crisis increasingly arises from the capital account.

On balance, the concern about reserves accumulation is largely unjustified. As financial globalization proceeds, central banks around the world have simply carried out their normal business of keeping their reserves in line with growing risks. The phenomenon is broad, affecting nearly every country. There are a few cases, mainly in Asia, where reserve accumulation seem to stretch beyond business as usual, but it may well be that these countries face particularly large domestic financial threats, especially in their banking systems.

Re-cycling of Petro-dollars – the risks of rising oil prices for developing countries

The issue of petro-dollars is a sub-set of the debate of international reserves. In the 1980's the hike in oil prices and the recycling of the ensuing liquidity was a supply shock for developing countries. A high volume of funds were on-lent to developing countries leading to the external debt crisis in the 1980s. Since oil prices are still on the rise now Mr. Lubin's paper looks into how petro-dollars are being deployed in recent times and whether it means new rising risks for the developing world, both as oil importers and borrowers. Mr. Lubin in his paper "Petrodollars, Emerging Markets and Vulnerability" pointed out that petrodollars have been an important source of support for asset prices in emerging economies, as well as benefiting net oil exporters. According to him, the overall effects of rising energy prices have probably been positive for many developing countries given that recent price increases have been driven from the demand side and reinvested in assets including those belonging to emerging economies. To elaborate, unlike in the 1970s, when they were intermediated through the international commercial banking system, petrodollars are today channeled directly into securities and asset markets. Thus, in the case of oil-importing emerging economies, their losses on the current account of the balance of payments emanating from higher oil prices are offset by gains on the capital account arising from the greater availability and inflows of finance. At the same time, Mr. Lubin pointed out that the location of credit risk has shifted from the commercial banks' balance sheet to the balance sheets of owners of petrodollars. He also cautioned that the positive relationship between asset prices and oil prices is probably not linear as very high oil prices can be linked with higher global risks that dampen investors' appetite for risk. Overall, according to Mr. Lubin, a number of oil-importing emerging economies have counter-intuitively been better off as a result of higher oil prices. Better data on deployment of petro-dollars by owners and reporting by debtors will make it easier to assess risks of high oil prices in the world economy.

Summary of Discussion

Mr. Christoph Lindemann expressed concern that the existing global imbalances cannot be sustained continue and the critical policy question is how to introduce the process of smoothening them out. Existing labor market and external conditions are important in gauging the appropriateness and sustainability of current strategies. To elaborate, East Asia's policy of accumulating reserves and undervaluing the currency is not dissimilar from the measures undertaken by Germany during the post-war period, with the key difference being that the latter was a fully employed economy whereas countries such as China have surplus labor. According to Mr. Lindemann, it is not clear whether reserve accumulation is a transitory phenomenon of developing countries or a trend that will continue unfettered into the future. He pointed out that, in the long run, this may not be an appropriate strategy for countries that have an abundance of labor and a shortage of capital. With respect to external conditions, Mr. Lindemann noted that a number of the Asian countries that were affected by the financial crises of the late 1990s today operate a flexible exchange rate system. On the other hand, some key countries that were not touched by the crisis, like China and India, continue to have a combination of a *de facto* fixed exchange rate and capital controls. The extent to which they decide to liberalize their external accounts will ultimately be determined by their economic fundamentals and the evolution of their financial sectors.

Mr. Das asserted that the sustainability of existing imbalances may depend both upon the fundamentals of the US economy and the ability of some key developing countries to diversify into other assets. He pointed out that about half of the stock of US dollars reserves are being held by central banks around the world. There would likely to downward pressure on the US dollar if these institutions cannot sustain their accumulation of US securities vis-à-vis other assets. Hence to be sustainable, this process of reserve accumulation, especially of US dollars, would need to continue and how far it can go depends on the capacity of the system to keep accumulating US assets.

Some participants pointed out that, in order to measure the costs and benefits of reserve build-up, it is necessary to identify its basis, which may in turn vary among countries depending on whether it arises from export expansion or import compression and whether the reserves are earned or borrowed For instance, India, representing a case of import compression, is different from Asian countries, which represent a case of export expansion; they are both different from Brazil, which has a combination of the two, as well as earned reserves rather than borrowed. At the same time, it was pointed out that a number of countries have been hoarding reserves in order to reduce their reliance on the IMF in the event of financial instability. There is nevertheless an information problem here in that countries do not really know the level of reserves needed for insurance and what is the surplus which can be used for investment. Moreover, there is also collective pressure to keep on purchasing reserves in order to ensure that the cost of capital is maintained vis-à-vis other countries that are also embarking on this strategy. Overall, it was emphasized that a number of developing countries have shifted from a strategy of debt management to asset management.

On the issue of asset management it was pointed out that Central Banks may need to reorient themselves into buying securities other than US bonds. With large reserves at hand, they need to work on a system that leads to a different composition of assets in order to develop other parts of the world. A participant also suggested that thought be given to how the current account surpluses in the South could be systematically channeled to countries that need finance and productive investment. Indeed, from a global development perspective, it was indicated that there is a maturity mismatch of world-side savings. While there are a huge amount of funds invested in the international capital markets, financing is still not available for longer-term projects in areas such as infrastructure. Policy makers need to address this and, in the meantime, consider how to channel the large level of reserves in developing countries into productive investment (

Inevitably, the issue of crisis prevention and resolution also generated attention from participants. Countries have been accumulating reserves mainly to address sudden reversals in capital flows, including capital flight. There was a call for a greater consideration of policies and/or international financial mechanisms that could address this problem. On this point, it was noted that regional financial integration could also serve as a defense mechanism against financial crises. There was also some discussion about the effects of credit derivatives and financial engineering in general on risk management in capital markets. According to a participant, identifying the location of credit risk, say from the recycling of petrodollars, may be much more complicated as a result of these tools. It was also argued that financial engineering along with loose monetary policies might have contributed to a mis-pricing of credit risk in the financial markets.

II The Linkages between Internal and External Debt and Debt Sustainability[4]

In recent years, developing countries have been advised to build local currency bond markets. Many countries have issued domestic bonds to pay off foreign creditors, so that external debt may have down but domestic debt has increased considerably to the extent that public debt sustainability is at risk. This session examined the issues involved in building up local currency bond markets and the linkages between internal and external debt for public debt sustainability. The issue is of relevance, both for middle income and low income countries.

Local Currency Bond Markets

A key message emanating from Ms. Gopinath’s presentation covering the Indian experience was that building up local currency bond markets takes times and care needs to be taken before this segment of the market is opened up to foreign investors. She also highlighted the difficulties involved in promoting corporate bonds. Local debt markets are comprised of Government securities (Central and State) and the corporate bond markets. Ms. Gopinath pointed out that India has been able to issue long-term paper in

[4] The session was moderated by Ms. Marion Williams, Governor, Central Bank of Barbados. The panel comprised Ms. Shyamala Gopinath, Deputy Governor, Reserve Bank of India; Mr. Yilmaz Akyuz, Former Director, UNCTAD; and Mr. Andres Rez, Department of Planning, Risk and Risk Management, Government Debt Management Agency, Hungary. The discussants were Mr. Edmund Fitzgerald, Professor, Department of International Development, Oxford University; and Mr. Ugo Panizza, Chief of Debt and Finance Analysis Unit, UNCTAD

the bond market; moreover most of the borrowings have been from domestic sources, and to a large degree from local banks[5]. Reforms in the early 1990s, relating to the financing of the growing fiscal deficit, and measures in later years to promote institutional development and enhance liquidity and efficiency all served to catalyze the development of the government securities market. All the borrowing is moreover in local currency. Ms. Gopinath proceeded to describe the corporate debt market in India. This has been in existence since 1947, but only after 1985 did some State-owned public enterprises (PSUs) begin issuing bonds, which were illiquid and unpopular. Financial institutions dominate public issues in the primary corporate debt market. She pointed out that corporations can borrow overseas, but this has been late to develop because they have access to bank credit and other forms of financing. Looking ahead, Ms. Gopinath stressed that it is necessary to continue the efforts to build a deep and liquid G-Sec market and recent reforms include the introduction of inflation-indexed bonds.

The linkage between internal and external debt and debt sustainability

Mr. Akyuz focused on the fiscal considerations underpinning debt sustainability in middle-income countries. He pointed out that the IMF framework for fiscal and external sustainability was developed as a result of the increasing significance of public domestic debt and private external debt in a number of developing countries. He proceeded to critique the IMF framework, which is based on the proposition that public debt cannot keep on growing relative to national income because this would require governments to constantly increase taxes and reduce spending on goods and services. However, while this describes the conditions for the debt ratio to remain stable, it does not indicate what exactly would be a sustainable debt ratio. Neither does this framework capture the dynamic interactions among the key parameters affecting fiscal and external sustainability. This is an extremely important issue since many countries need 'fiscal space' to undertake investment in infrastructure and social services. Mr. Akyuz argued the IMF looks at fiscal space as what is left after servicing debt and went on to propose a number of ways through which countries can create fiscal space, including through improving the efficiency of public spending, increasing revenue mobilization, and attracting grant aid and new borrowing. In this respect, he also underpinned the need for a viable system of debt restructuring and workouts.

Improved debt management practices to promote debt sustainability

In order to understand further the linkages between internal and external debt and the value of debt management strategies Mr. Rez adopted a balance sheet approach pointed to the usefulness of having a sovereign asset-liability management strategy as a means of managing public debt in developing countries. Such strategies have been used by banks to manage assets and risk and to undertaking hedging. While its application by governments may not be straightforward, not least because it is difficult to define sovereign assets, it could provide a useful benchmark. Mr. Rez also discussed the

[5] Though the Central government can borrow from both internal and external sources, unlike the state governments which can only borrow domestically. There is concern that encouraging greater investment from foreign investors could lead to exposure to volatile capital flows.

Hungarian case where government securities were developed in the 1990s and there was a clear separation between domestic debt and external debt during this period. However, Hungary has since successfully managed both components of debt and moreover has also handled its foreign exchange reserves well. Hungary provides a useful illustration of pro-active debt management strategy to promote debt sustainability via a balance sheet approach to debt management.

Summary of Discussion

Mr. Fitzgerald commented on the issue of the local currency bond market in India, he wanted to understand why the corporate bond market is relatively underdeveloped. This is interesting because a growing government securities market should facilitate the development of the corporate debt market through providing a benchmark yield curve. The fact that this has not happened could be because of underlying problems relating to corporate governance. It may also indicate that government securities may be absorbing savings that should otherwise be channeled to the private sector and, in particular, small and medium enterprises. On the issue of fiscal considerations underlying debt sustainability, Mr. Fitzgerald emphasized the importance of tax reform. Finally, he agreed an asset-liability approach may be a useful way of managing public debt. However, he pointed out that the issue is far more complicated at present because of increasing private borrowing and debt. The size of the currency and other liabilities of the private sector, including commercial banks, are unclear; in many instances the risk has been transferred from the public to the private sector and, according to Mr. Fitzgerald, the next series of crises could arise from company balance sheets.

Mr. Panizza pointed out that the structure and composition of debt also contributes to the level of risk, perhaps even more than the level. He added that the high volatility of spreads is another risk. Mr. Panizza also mentioned that in the real world a change in the stock of public debt does not necessarily equal the fiscal deficit due to technical measurements, hidden fiscal liabilities and changes in the composition and value of debt arising from factors such as currency devaluations.

There was discussion of capital account liberalization and its implications for debt management and bond market development. The question was raised as to how India's experience in bond market development may have varied had there been an open capital account. In this respect, it was also pointed out that the difficulties in simultaneously managing internal and external debt have also been a function of increased activities on countries' balance of payments capital account. In this respect, it was also pointed out that the liberalization of capital accounts makes it all the more important to address issues related to corporate balance sheet vulnerability.

III Financial Architecture – Crisis Prevention[6]

Financial crisis in a country can emanate from unsustainable debt position driven by domestic policies or be a consequence of events in international markets. The openness of the capital account can have implications for both debt sustainability and financial stability.

International Financial Architecture

According to Mr. Fried, the underlying causes of financial crises include global macroeconomic imbalances, weak financial systems, inadequate legal and accounting frameworks and information asymmetries that create uncertainty. He proceeded to outline a range of policy responses. He began by pointing out that IMF surveillance assists in crisis prevention by providing countries with assessment of risks and their weaknesses. However, it can be improved through incorporating analysis of the financial sector, developing new models of exchange rates, improving disclosure and analyzing the dynamics behind contagion. Moreover, according to Mr. Fried, the IMF is also committed to providing technical assistance to countries to manage and reduce asset-liability mismatches. Thirdly, he argued for the development of local financial markets, and in particular bond markets, pointing out that they can reduce currency and tenure mismatches arising from borrowing overseas. Mr. Fried also pointed out that the IMF provides facilities that help to stem crises, if they arise. A new instrument, the Reserve Augmentation Line could provide countries large sums unconditionally to pre-qualified countries. Lastly, he emphasized the importance of debt relief in creating fiscal space for growth enhancing spending.

Capital Controls

Mr. Frieda assessed issues relating to capital controls and capital account liberalization. He outlined the objectives of capital controls as relating to the need to strengthen the effectiveness of monetary policy, reduce exchange rate volatility and reduce the likelihood of crises. Moreover, the increase in private sector borrowing in many emerging economies has also led to a stronger rationale behind capital controls. At the same time, he stated that a range of issues and trade-offs need to be considered. For instance, policy makers will need to decide which specific flows to target and the type of controls to employ. There is also the issue of whether a country has the requisite administrative capacity to implement capital controls; in this respect, it is important that countries avoid unenforceable controls. According to Mr. Frieda, it is also important for countries to assess the degree of monetary control brought about by capital controls and balance this against the benefits that additional capital inflows may have brought. On the topic of

[6] The session was moderated by Mr. Tony Venables, Chief Economist, Department for International Development, UK. The presenters were Mr. Jonathan Fried, Executive Director for Canada, Ireland and Caribbean, IMF; and Mr. Gene Frieda, Head, Emerging Market Research, Royal Bank of Scotland. The discussants were Ms. Marion Williams, Governor, Central Bank of Barbados; and Ms. Stephany Griffith-Jones, Professor, Institute of Development Studies, University of Sussex.

capital account liberalization, Mr. Frieda argued for a gradualist stance and said that inflows should be liberalized before outflows; though the sequencing ultimately depends on a country's macroeconomic environment and its vulnerability to external shocks.

Summary of Discussion

Ms. Williams pointed out that the IMF has been more flexible on the issue of exchange rate regimes and even provided support for the fixed exchange regime adopted by Barbados. She also highlighted the fact that while more countries have floated their currencies, these have been managed floats. Nevertheless, increasing financial integration will make it increasingly difficult for fixed exchange rate regimes to operate and, with increased movement of funds and people; it will also be harder to maintain capital controls. Ms. Williams emphasized the need to correctly sequence capital account opening in a gradual manner, and argued that it should progress from inflows to outflows to bond markets and, last of all, equity markets. On the issue of the international financial architecture, Ms. Williams stressed the need for closer analysis of financial market behavior, including herding behavior and ensuring greater transparency of all categories of financial transactions. Stronger oversight is also needed by monetary authorities across the world.

Ms. Griffith-Jones argued that any abrupt adjustment of imbalances would affect developing countries in different ways. It is nevertheless important to consider how they can protect themselves. At one level, according to her, better hedging by companies against exchange rate risk could make it easier for the authorities to conduct monetary policy and deal with the impact of abrupt devaluations. At the same time, Ms. Griffith-Jones cautioned that there are new and emerging sources of vulnerability that make it necessary for policy makers to try to anticipate the sources from where possible crises could arise. For example, there are new sources of risk coming from instruments such as derivatives and from the activities of hedge funds. Derivatives can shift risk to those who can carry it, but problem arises when the hedging activities of some large companies have a pro-cyclical impact. Indeed, according to Ms. Griffith-Jones, financial markets tend to be pro-cyclical in general. To respond to this, she called on policy makers to introduce counter-cyclicality in banking regulation and in market instruments. She cited GDP-linked bonds as an instrument that could limit pro-cyclicality in good and bad times and reduce the likelihood of defaults. Moreover, according to Ms. Griffith-Jones, such an instrument, through promoting financial stability, may produce positive externalities for both investors and the global economic system at large.

Comments were made regarding the stability of financial flows. It was pointed out that, while investors are now increasingly differentiating between countries, the latest analysis seems to suggest that there is a huge amount of herding behavior going on with money pouring into some emerging economies. The concern is that this is likely to reverse at some time. It was also suggested that the Fund should study the impact of proposed monetary unions in the Gulf and the Caribbean between 2010 and 2015.

On the issue of capital controls and regulation, it was pointed out that there has been little research on best practices with regard to capital controls. A number of participants agreed that open capital accounts are not appropriate for many developing countries today. It was stressed that China and India were sheltered from the Asian crisis, possibly because they had quite closed capital accounts, that capital controls were very effective in Malaysia and that the existence of multiple equilibria in financial markets justifies capital controls in many developing countries. While one participant argued that, as countries liberalize their capital accounts, they should only open up in areas that they are able monitor and regulate, another countered that this may not be practically possible and may render the whole process of capital account liberalization meaningless. Rather, according to the latter point of view, the key issue concerns which markets and players to regulate. More broadly, it was also pointed out that the whole issue of capital account liberalization needs to be revisited in a political economy context. For a start, it needs to be looked at not just in terms of regulating foreign investors but also as a means to prevent domestic capital flight. Moreover, the whole process may be underpinned by social factors. For example, the recent imposition of capital controls in Thailand had to be reversed most likely because it affected the interests of the politically powerful middle classes who had built up an active stake in the stock market.

Other topics discussed included standard and codes, financial instruments and lending facilities of the IMF. While the whole idea of standard and codes is to educate the financial markets, it was noted that the private sector do not take them into account when making lending and investment decisions.

III Financial Architecture (Continued) – Orderly Debt Workouts[7]

The failure of the IMF in getting stake-holders to accept its proposed Sovereign Debt Restructuring Mechanism has left a vacuum in the international debate on orderly debt workouts. This session invited views from the private sector, academia and international organizations to assess the state of present approaches to debt restructuring and recommend the way forward.

Private sectors views on orderly debt workouts

Mr. Chamberlin argued that while country debt restructuring is more likely to occur in the present environment, where there is pending legislation against a sovereign, it is nevertheless difficult to enforce legal action. In many respects, recent experiences may have favored debtors and, for example, many investors believe that Argentina's debt

[7] The session was moderated by Mr. Chukwuma Soludo, Governor, Reserve Bank of Nigeria. The presenters were Mr. Michael Chamberlin, Executive Director, Emerging Markets Trade Association; Mr. Barry Herman, Senior Fellow, New School University; Ms. Shari Spiegel, Managing Director and Head of Research, Initiative for Policy Dialogue, Columbia University; and Mr. Richard Segal, Chief Strategist, Argos Fund Management Group. The discussants were Mr. Marcus Miller, Professor of Economics, Warwick University; and Ms. Benu Schneider, Chief of International Finance, Debt and Systemic Issues Unit, UN-DESA Financing for Development Office.

restructuring offer was inadequate. Having said this, Mr. Chamberlin pointed out that there is a quite significant spectrum of private sector attitudes and, in the final analysis, creditor reactions to restructuring depends to a degree on how effectively a debtor country interacts with lenders. According to him, this process of engagement between debtors and creditors is ad hoc and mechanisms need to be developed to make it more orderly, predictable and constructive. To make it so, incentives could be provided in the form of new lending by multilaterals and new contractual agreements. According to Mr. Chamberlin, rating agencies could also be drawn into the process of making the restructuring process constructive and forward looking by advising what it would take for countries to re-enter the market, though this may be limited by the fact that the different agencies sometimes have different views.

Mr. Segal compared two recent debt restructuring episodes, in Belize and Ecuador, in order to contrast different approaches to sovereign debt restructuring. Belize has just completed a successful restructuring that has extended the maturity of its external debt, which had been climbing unsustainably. While the government resisted an IMF program, it nevertheless used collective action clauses to its advantage (which reduce the incentive of rogue creditors to buy debt just with litigation in mind). By contrast, Ecuador has appeared intent on rescheduling even though there is no sizeable debt burden and its approach seems less credible. Having summarized and drawn numerous conclusions from each country's experience, Mr. Segal proceeded to discuss debt restructuring trends in general, suggesting among other things that there has always been a role for an independent international arbiter and clearing house of information, that the IMF's lending into arrears policy should be reviewed and clarified with a high level of private sector input, and that the time is ripe for re-evaluating the concept of preferred creditor status. He pointed out that, while debt restructuring frameworks are more transparent, information asymmetries still exist and creditor coordination is not perfect.

Sovereign Debt Restructurings - A Piece of Financial Architecture is still Missing

Mr. Herman and Ms. Spiegel gave a joint presentation focusing on the fact that there is no international system of law on how to deal with sovereign defaults and bankruptcy. Whenever a default occurs, the subsequent restructuring follows an ad hoc path as the different stakeholders negotiate for the best deals. According to them, the existing market based mechanisms are not efficient in that investors are being paid for cost of default without absorbing the cost of default. The end result is that, even after the crisis gets resolved, countries are not in a position where they can fully recover from debt problems and embark on a sustainable growth path. In looking for solutions, the presenters pointed out that there is a need for more powerful instruments as the voluntary code of conduct does not appear to work. While not proposing specific remedies, they mentioned that before the Second World War there was an international treaty that proposed arbitration as a way of handling debt crises. They also pointed out that proposed Sovereign Debt Restructuring Mechanism (SDRM) may not have been feasible, but it nevertheless had some positive features that should not be forgotten. For instance, it embodied mechanisms for creditors to coordinate their positions within and across different classes of lenders and had a well-designed process that could protect the rights of minority as well as majority creditors. Overall, Mr. Herman and Ms. Spiegel concluded that for debt resolution to be timely, effective and fair, some stronger initiative is needed that uses the state and law in a different way and that facilitates the sharing of risks and responsibilities.

Summary of Discussion

Mr. Miller, pointed out that neither the IMF, nor the Paris Club, provide countries with fresh start after a default. Countries receive breathing space but not a new beginning that enables them to shake off their debt problems and embark on a sustainable growth path. There is therefore a need to focus more on the end result rather than intermediary targets and also to realize that a hasty debt write-off would be damaging for countries. He also pointed out that the SDRM had credible features, though it was dropped in favor of collective action clauses, and referred to the view of Arturo Porzekanski (a former market participant and currently an academic specializing in international finance) that, especially after the Argentinean experience, the problem of rogue debtors is as critical as that of rogue creditors.

Ms. Schneider pointed out the discontent with present mechanisms for both private and official debt amongst all stake-holders. She questioned the role of the official sector, credit rating agencies, and the criteria adopted by creditors. In response to the Belize case study she argued that collective action clause based debt restructuring had only provided breathing space in Belize. Referring to the problem of serial rescheduling in Paris Club debt restructurings, she pointed out that short consolidation periods were chosen by creditors to keep debtors on a short leash. This combined with the mistakes in projections by the IMF had a snowballing effect on debt because of bunching of repayments due to lower grace periods; market interest on non-ODA on new reschedulings; and new credits issued after debt reschedulings. She questioned why lenders continued to pour money after a rescheduling and what reforms can be undertaken to ensure responsible lending. She provided evidence that transparency had not led to better assessments by creditors.
Ms Schneider argued that there were problems in the signaling mechanism in the world economy. The signals sets out by the IMF were over optimistic affecting the viability of a debt restructuring. The dominant bottom-up (surveillance has a strong country orientation) approach yield consistently overoptimistic forecasts for certain regions and does not sufficiently pick policy spillovers in a global context. Credit ratings by credit rating agencies also fail to pick up country differences in the levels of riskiness.

The IMF, according to Ms. Schneider has become increasingly involved in mediating debt-rescheduling agreements between debtor countries and official creditors through its role in the Paris Club and through this role the financing of a Fund Programs has often become dependents on debt relief. The amount of debt relief is contingent upon a Fund Program and its estimate of financing gap and debt sustainability analysis. Improvements are needed in the estimation of these by the IMF. There is no compatibility between the role of the IMF as gatekeeper for concessional resources and, on the other hand, creditor and therefore a stakeholder in the inflow of the same resources. There is thus an issue of moral hazard at the BWIs.

IV Some Issues in Low Income Countries[8]

In recent years some inter-related themes have been subjects of policy debate. The issue of scaling up of aid flows to developing countries, IDA allocation on the basis of a new joint IMF World Bank debt sustainability framework for low-income countries and whether increased lending by some non-OECD members can be termed free riding on the debt relief give by the Paris Club. These issues were taken up in this session.

Scaling-up of Aid Flows

Ms. Schneider began her intervention citing recent trends and issues in ODA in low income countries. She noted that in spite of increases in the volume of ODA since 2002, ODA had fallen in 2006 and falls short of the internationally agreed targets needed to meet the MDGs. Also, she emphasized that aid flows are characterized by selectivity, uncertainty and volatility, and that they pose the same macroeconomic management challenges as private capital flows. In particular, Ms Schneider presented the cases of Uganda, Mozambique, Ghana and Tanzania to show that sterilization of donor inflows has led to an increase in domestic indebtedness and high interest cost affecting public debt sustainability and an outflow of foreign exchange by the commercial banking sector. This has crowded out the take off credit to the private sector. She emphasized the risk of reversibility of donor flows, and suggested that recipient countries should in response increase domestic savings and revenue, employ part of donor funds for export diversification, infrastructure development and financial sector reforms and, in addition, ensure that interest rates are stable. The huge build-up of domestic debt for sterilizing liquidity could have been avoided if conditionality could have been relaxed to use the surge in donor flows for investment in productive and trade capacity. Ms Schneider also advanced a proposal for a new mechanism to intermediate aid flows. Specifically, she suggested the establishment of a trust fund outside the recipient countries that would intermediate aid flows and thereby mitigate volatility and the impact of aid on liquidity. This fund would be controlled by a board set up by donors, while portfolio management delegated to the BIS.

Debt Sustainability Framework (DSF) for Lower Income Countries

Mr. Kappagoda provided an assessment of the Debt Sustainability Framework (DSF) for Lower Income Countries prepared jointly by the IMF and the World Bank in November 2006, reviewing the application of policies and developments relating to the Country

[8] The moderator of this session was Mr. Bryan Sanderson, Former Chairman, Standard Chartered Bank. The speakers were Ms Benu Schneider, Chief of International Finance, Debt and Systemic Issues Unit, UN-DESA Financing for Development Office; Mr Nihal Kappagoda, Debt Management Consultant, Ottawa; and, Mr Matthew Odedokun, Economic Advisor, Economic Affairs Division, Commonwealth Secretariat. The discussants were Mr Reisen and Professor Andreas Antoniou, Professor, Adviser and Head of International Finance and Capital Markets Section, Economic Affairs Division, Commonwealth Secretariat.

Policy and Institutional Assessments (CPIAs) performed by the World Bank to determine debt distress, the implementation of the IDA 14 Grant Allocation Framework and the MDRI and HIPC Initiatives. In particular, he stressed the importance that low income countries that have benefited from debt relief avoid future accumulation of unsustainable debt levels. Mr. Kappagoda also criticized the indicators used to determine debt sustainability levels, and argued that the present approach raises a number of conceptual and analytical issues. He then highlighted the challenges ahead, calling for a continuing review of various aspects of DSF in the context of its objectives to assist lower income countries avoid the accumulation of unsustainable public debt levels and provide a mechanism for the IDA to assess grant-eligibility for IDA-only countries. In particular, he proposed reviewing debt indicators and thresholds, integrating domestic debt into the DSF, monitoring vulnerabilities arising from non-concessional commercial borrowing, fostering creditor coordination, improving data quality and reporting to the international financial institutions and improving public debt management.

Free rider Assessment by the Fund and Bank

Mr Odedokun reviewed trends in non-concessional borrowing in low income countries, illustrating that countries rich in natural resources and countries in conflict account for the bulk of non-concessional debt stock and flows, particularly public and publicly guaranteed types. He in particular highlighted the geographical concentration of this type of bilateral lending, warning that this could make borrowers more vulnerable. Mr Odedokun also assessed the World Bank's document on anti-free riding policy proposal, pointing out the positive aspects as well as the drawbacks of this[9]. On the positive side, he mentioned that the proposal should contain opportunistic lending to low income countries and the subsequent moral hazard problems. It should also serve to discourage lower income countries from undertaking excessive borrowing prior to strengthening their debt management capacity. On the other hand, he asserted that the World Bank should not see itself as a competitor to other creditors and highlighted the problematic aspects of IDA assistance to lower-income countries as well as the need for additional finance to facilitate the achievement of the MDGs. Finally, Mr Odedokun presented some recommendations for ensuring debt sustainability in low income countries. These included the suggestion that borrowing countries should strengthen their governance and macroeconomic management capacities, as well as refrain from borrowing recklessly. At the same time, he stated that the World Bank should promote debt management capacity in low income countries and help them diversify their export base.

Summary of discussion

Mr. Antoniou noted that the macroeconomic implications of scaling-up aid flows are still an unsettled issue. Countries should work to improve absorption capacities and also strengthen their policy fundamentals and governance. While acknowledging the merits of Ms Schneider's proposal to set up a new trust fund to intermediate aid flows, Mr.

[9] In March 2006, the World Bank prepared a paper for its Board on how to deal with the problem that free riding poses for it. In this particular case, a free rider is used to refer to situations in which IDA's debt relief or grants could potentially cross-subsidize lenders that offer non-concessional loans to recipient countries.

Antoniou questioned whether there would be support for the establishment of a new institution. He pointed out that there is also the issue of how disbursements by such a fund could be synchronized with recipient countries' monetary policies. Mr. Antoniou also suggested that CPIAs should include a provision related to the attainment of the MDGs and, moreover, agreed that the World Bank sees itself as a creditor competitor. He finally suggested that the Commonwealth Secretariat should use its technical capacity to assist developing countries in implementing General Equilibrium Models for macroeconomic management.

Mr. Reisen expressed his concern that internationally agreed targets of ODA are not being met. He also warned about the misinformation surrounding the aid debate, noting that the recent increase in donor flows is largely explained by debt relief. Mr Reisen also commented on the build up of domestic debt in many low income countries as a result of sterilization policies, arguing that this is not an issue if private credit is not crowded out. He then dwelled upon the rise of China as a key donor to Africa, pointing out that China's engagement could well represent a new strand of the aid architecture. According to Mr. Reisen, Chinese finance has enabled infrastructure building in Africa is proceeding at a faster pace and lower cost. He also called for the strengthening of standard and codes in critical sectors in less developed regions.

IV Some Issues in Low Income Countries (Continued)[10]

Debt Restructuring

Mr Aliyu gave a historical account of Nigerian external debt restructuring with the Paris Club and the London Club as well as of domestic debt restructuring. He stressed that the need to restructure bilateral official debt arose as resources needed to be released to tackle the unsustainable levels of poverty in the country and the commitment to attain the MDGs. This was reinforced by the election of a new democratic government in 1993, and the ensuing entry of the notion of "odious debt" into the political discourse. The basis for negotiation was the policy instrument agreed with the IMF in 2004. Attention, according to Mr Aliyu, soon shifted also to the London Club and the exit strategy in this case focused on repurchasing promissory notes. At the same time, Nigeria also started to tackle domestic indebtedness, and established a strategy to lengthen the maturity of short-term securities that were sold to investors in order to finance the fiscal deficit. Mr. Aliyu also pointed out that, in order to avoid a relapse into unsustainable debt, Nigeria has made efforts to strengthen its policy fundamentals. He finally emphasized the importance of maintaining sound debt management, developing a domestic capital market and dealing with sub-national debt.

[10] The second part of the session on issues in low income countries was chaired by Mr. Ransford Smith. The main speakers included Mr Yakubu Aliyu, Director, Portfolio Management, Debt Management Office, Nigeria; Mr Dinesh Dohdia, Consultant, Commonwealth Secretariat, London; and, Mr Vijay Kumar, Director, CBC Trade Exchange, London. Discussants were Professor Nissanke and Ms Alison Johnson, Programme Manager, Debt Relief International, London.

Domestic Debt Architecture in the Context of the Millennium Development Goals

Mr Dohdia reminded participants that the attainment of the MDGs represents a major challenge for low income countries. While it is important to scale up ODA and external debt relief, he also emphasized the importance of freeing up the resources currently employed to service domestic debt and redirecting these towards the MDGs. He also pointed out that the level of domestic debt in many low income countries is underestimated because of data deficiency, is characterized by short maturities and sole to a concentrated base of investors. While expounding the rationale for domestic debt relief, Mr. Dohdia suggested a number of initiatives that low income countries should implement to manage the domestic debt burden, including improving information and databases on domestic indebtedness; promoting debt sustainability, with a view to freeing resources to attain the MDGs; focusing on sound policies that both promote growth and ensure macroeconomic stability; and restructuring existing debt. He pointed out that donors could assist this process through providing appropriate financial and technical assistance.

Mr. Vijay Kumar addressed the issue of remittances and microcredit, stressing their potential positive impact on poverty reduction if the adequate infrastructure is put in place. Focusing on Uganda, which is one of the countries where the Commonwealth Business Council is currently working, he highlighted the importance of developing the banking system, reducing transactions costs and strengthening governance. Pointing out that remittances represent a significant fraction of capital flows in Uganda, Mr. Kumar argued that they are hindered by high transaction costs. To address this issue, the Commonwealth Business Council has recently introduced a new e-banking transfer system. Mr. Kumar also illustrated that microfinance in Uganda is characterized by high interest rates, poor geographical reach, low transparency and minimum competition. Microcredit institutions there also lack technological development and economies of scale. He mentioned that the Commonwealth Business Council is working to build appropriate infrastructure to make microcredit work more effectively in Uganda and, in particular, is active in introducing ATM, back office facilities and mobile technology.

Summary of discussion

Ms. Nissanke, building on Mr. Dhodia's presentation, argued that the underlying factor behind the unsustainable debt levels faced by many low income countries is low growth. There are many reasons why many low income countries exhibit low growth rates, including weak institutions and low investment. This also makes it difficult for these countries to attract private capital. Ms. Nissanke also noted that investing in social capital is a necessary though not sufficient condition to spur growth. What is of fundamental importance though, if growth is to take off, is investment in infrastructure. She also commented on the weaknesses of the HIPC Initiative, owing in particular to its negligence of external shocks, and argued that the existing debt sustainability framework needs to be more forward looking.

Ms. Johnson argued that the fact that donors do not deliver aid on time serves to aggravate the pressures of indebtedness of many countries. She pointed out that domestic borrowing is necessary if low income countries want to achieve the MDGs since external financing, including aid, is inherently volatile. She also noted that in many instances donors have been pushing for the development of capital markets in countries where this may not be appropriate. These countries usually lack the required physical, legal and technical infrastructure for capital market development. It is, therefore, necessary that financial development is characterized appropriate sequencing and capacity building.

V. The Monterrey Process on Financing for Development: The Road Ahead[11]

The international economic environment has changed since the Monterrey Consensus in 2002. Some developing countries have gained economic strength and are investing in industrialized countries. There is a transformation in economic power. The financial integration in Europe has been a success. Other regional groups have made progress but other not, due to failure of the WTO talks far. The promotion of trade, investment, economic cooperation, and the mobilizing of international resources under the Monterrey Consensus have fallen short of the needs of the world economy. International financial architecture and financial stability continue to remain concerns. Some of the main issues highlighted were as follows:

A. Aid and debt relief for low-income countries: The general view was that although progress has been made since the Monterrey Consensus in 2002 in areas of debt relief and aid, further progress was needed in these areas.

Aid targets: Progress had been made in the areas of debt relief and increasing ODA since 2002. But this progress is insufficient and further efforts are needed to meet the shortfalls in meeting commitments. Insufficient aid flows had been forthcoming to finance the MDGs and other development goals. Steps have to be taken to move forward in providing multilateral and bi-lateral debt relief for all low income countries and not only those that meet the HIPC criteria. These moves need to be accompanied by new

[11] A summary of plenary session and panel discussion. The plenary session was moderated by Mr Mohan Kaul, CEO and the Commonwealth Business Council. The panel included The Rt. Hon Stephen Timms, MP, Chief Secretary to HM Treasury, London; Hon Rohita Bogollama, Foreign Ministry of Sri Lanka; Mr Ocampo; and, Mr Ransford Smith, Deputy Secretary General (Development), Commonwealth Secretariat. This session was devoted to a high-level exchange of views and thoughts on the theme of the workshop.

The panel discussion on "The Monterrey Process on Financing for Development: The Road Ahead" was chaired by Ms Benu Schneider, Chief of International Finance, Debt and Systemic Issues Unit, UN-DESA Financing for Development Office. The panelists were Mr. K.S. Jomo, Assistant Secretary-General on Economic Development, UN-DESA; Mr. Indrajit Coomaraswamy, Director, Economic Affairs Division; and Mr. Frank Schroeder, Senior Economist, Friedrich Ebert Stiftung.

concessional lending to finance country-owned development strategies and actions that ensure debt sustainability.

Aid allocation: The present system of aid allocation is leading to the problem of donor darlings and donor orphans raising questions about the signaling mechanism for aid delivery. In addition donor flows are characterized by volatility and herding. In the case of donor darlings, surges of aid flows in some recipient countries have lead to sterilization costs as the aid flows were very high as a percentage of GNP. The sterilization costs have been in the form of high domestic debt constraining the fiscal policy space for development expenditure. Policy action is needed to improve aid selectivity and ensure stable and predictable long-term aid flows aligned with national development strategies. Thus changes in the terms of ODA, especially in the form of direct budgetary support, grants instead of loans, improved delivery systems and increases in the volume of aid are needed. A trust fund may also be set up to disburse payments and addressing the problems of volatility and predictability. Greater consideration of aligning aid flows to national development strategies to support internationally agreed development goals is needed. These strategies should be acceptable to the international community and the fiscal space created to implement them via grants, loans and equity where appropriate.

New donors: On the issue of increase in aid flows from some non-DAC donors, looking in particular at the active role of China in Africa, the critical debate is whether there exists a ‘free rider’ problem, as opposed to the view that China’s efforts to finance infrastructure should be viewed as complementary to programs by existing donors.

Aid for trade: The gains from trade liberalization have not met expectations, and inherent in it is the danger that aid for trade may divert funds that may have been channeled into other forms of development assistance. This aspect of aid for trade requires further study, including the compensatory aspect (that compensates countries for their loss of tariff revenue and the collapse of productive and export capacity) and the development of new capacities.

Aid and Innovative Sources of Finance: The effort by some countries to push for remittances as substitutes for aid is misplaced. Innovative sources of finance such as initiatives on carbon trading markets and compensation to reduce deforestation are at the forefront of analyses today.

B. Mobilizing domestic financial resources for development

Revisiting the link between savings and investment

There is a need to revisit the relationship between savings and investment. While the traditional focus has been to mobilize savings which then flows into investment, there is also evidence that savings follows investment. In any case, the whole issue of the drivers of investment needs to be examined, not least since some of the traditional theories regarding the importance variables such of say property rights need to be reviewed in the context of the experience of countries such as China. In addition, factors such as the functional distribution of income may also have a bearing on the type and level of investment.

Taxation

The capacity of developing countries to tax has been greatly undermined in recent years and that ways of overcoming this problem need to be examined. At the UN, much more work has to be done to advance international cooperation on taxation in order to reverse the current race to the bottom as governments lower taxes to attract investors with 'beggar thy neighbor' consequences. All too often, developing countries' capacity to tax has been greatly undermined with the reforms which have taken place over the last couple of decades. The ability to overcome such problems is extremely important for restoring fiscal space and government capacity to act developmentally and equitably.

Employment generation

How countries can transition from vicious to virtuous cycles of growth and creation of employment? This needs to be studied in the context of recent experience where there has been an improvement in growth in developing countries that has little to do with economic reforms and, moreover, has not led to a significant increase in employment. Here, there are at least two issues: In the last half decade, there has been more growth in many developing countries, but this has had very little to do with preceding economic reforms. We have to better understand what made recent growth possible, including higher commodity prices as well as lower interest rates, and how to sustain it. But on the downside, we must also recognize that recent growth has not been accompanied by commensurate improvements in employment. We all know there can be no sustainable reduction of poverty without employment expansion. There is recent attention in ECOSOC and the ILO to the employment implications of recent economic growth, but we need to give this much more attention.

C. International Trade

In the trade area the debate has settled significantly in recent years. There is now general agreement, including World Bank research, that further trade liberalization offers very modest, one-shot output gains, mainly for the few leading agricultural and manufacturing exporters, with adverse consequences for others including the reduction, if not the elimination of existing productive capacities in manufacturing as well as agriculture. The implications for poverty reduction are even direr. For countries just beginning to develop, to industrialize, to develop productive capacity, premature trade liberalization will reverse the developmental process.

Speakers emphasized the need for assistance to least developed countries to address the special concerns of small economies such as the need to address the support system for agriculture/commodities in developed economies such as the US, and special and differential treatment and economic partnership agreements between the European Union and least developed countries.

D. Debt and private capital flows

On the issue of debt, the levels of indebtedness in lower and middle-income countries are still unacceptably high and steps need to be taken to support better debt management and the building of institutional capacity in this area. The debt restructuring mechanism beyond collective action clauses for middle income countries was deemed necessary for a stable financial system. Concerns relating to the relative benefits and risks associated with different types of private flows were highlighted. In this context, it was pointed out that there may be not be much difference between certain forms of FDI and portfolio flows. Another area of concern is the issue of net resource flows from South to North, where even Africa has experienced a net outflow.

While considerable work has been undertaken on corporate finance and microfinance, there has been little analysis of ‘SME access to finance’ i.e. the missing middle. It was also suggested that the issue of developmental finance needs to be revisited.

E. Key issues in the International Financial System

Progress in multilateral cooperation in trade and finance chapters of the Monterrey Consensus was unsatisfactory. Financial crises can put lives at risk. Currency speculation is extremely harmful and corrective actions against this must be taken.

Some key issues and concerns relating to the global economic and financial system were highlighted. The build-up of reserves and global imbalances pose risks for countries and reflect the by many emerging markets is their view on international cooperation. One of these concerns the size of the risk embedded in credit derivative markets, which is not known with any certainty. Better information, surveillance and analysis on this would be necessary, as well as on other issues such as, for example, where the petrodollars are being invested. Global imbalance and the accumulation of reserves by developing countries is also a symptom of their view that international cooperation in the area of global finance is unlikely. In this sense, institutional reform, including greater empowerment of developing countries in the existing multilateral institutions, can be seen as part of a longer-term remedy to the problem of global financial instability and imbalances Many middle-income countries have undergone significant fiscal adjustment, and a reduction in public debt, the indebtedness of their private sector has increased. In such economies, it becomes all the more paramount for policy makers to consider means and mechanisms of managing the boom/bust cycles of the private sector. The exacerbation of instability by financial globalization was stressed and issues relating to the pursuit of counter-cyclical capacities imperative. Some doubts were raised about the trade-offs created by anti-inflationary policies in many countries which follow from recommendations by the IMF. Other issues which warrant consideration include crisis prevention; the need to assess contagion and sources of vulnerability such as hedge funds; international governance issues such as the voice and participation of developing countries in key international organizations; and promoting regional financial cooperation.

The four pillars to move forward are:

1) Regional cooperation programs

2) Trade & investment cooperation

3) Monetary integration

4) Public goods integration

Savings need to be mobilized with the help of international organizations. The Bretton Woods institutions need to be more farsighted, so that financial integration is complementary to trade integration.