Report
Multi-stakeholder Workshops on Debt, Finance and Emerging Issues in Financial Integration

The Financing for Development Office organized two workshops on "Debt, Finance and Emerging issues in Financial Integration" with financial support from the Government of Norway. The first workshop was organized in partnership with the Commonwealth Business Council and Commonwealth Secretariat in London on 6 and 7 March 2007 and a follow-up workshop on 7 and 8 April 2008 in New York[1] 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 discussions and papers[2] fed 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, held in Doha (29 November-2 December 2008).

The workshops consisted of plenary sessions and presentations of substantive papers to initiate discussions as well as panel discussions on the policy issues in financing development on the Road to Doha. The mix of speakers and participants from international organizations, private sector, civil society and academia added to the richness of the discussions and represented views across the board. The papers were made available on the Financing for Development Office website[3]. The New York workshop was well attended by delegates, eliciting active participation and interest in the substantive papers presented at the meeting. The discussions with delegates continued well after the workshop was over, also in the preparation for the Doha Conference.

Meeting 6-7 March 2007, Commonwealth Secretariat, London (report submitted)

Meeting 8-9 April 2008, United Nations Headquarters, New York

The conference was opened by H.E. Johan L. Løvald, Permanent Representative of Norway to the United Nations, H.E. Maged A. Abdelaziz, Permanent Representative of Egypt to the United Nations, Co-Chairs of the preparations for the Doha Review Conference and Sha Zukang**,** Under-Secretary-General for Economic and Social Affairs.

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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] Thirteen papers were commissioned from the Norwegian funds, 2 by the Commonwealth Secretariat who also hosted the meeting in London, and 5 paper contributions from the private sector and international institutions. In addition panel discussions were organized in both workshops on a discussion on the "The Road to Doha."

[3] The papers are posted on the special events page on www.un.org/esa/ffd.

The opening remarks covered the modalities and process for the preparatory work for the review of the Monterrey Consensus in Doha in December 2008. It was recognized that the workshop could provide important input to the preparatory process, serving as a useful platform for hearing the views and recommendations of Member States and bringing forth ideas on which they could reach a consensus. The opening remarks were followed by an interactive discussion with participants.

Session I: The Monterrey Process on Financing for Development: The Road Ahead

The first session was a panel discussion, chaired by Oscar de Rojas, Director, Financing for Development Office, with four speakers as follows: Jomo Kwame Sundaram, Assistant Secretary General, Department of Economic and Social Affairs, United Nations, Roger Kubarych, Chief U.S. Economist, Economics and Commodity Research, UniCredit Markets & Investment Banking, Bayerische Hypo und Vereinsbank AG, New York, V. Leeladhar, Deputy Governor, Reserve Bank of India, and Roy Culpepper, President, North-South Institute, Ottawa.

The first speaker, **Jomo Kwame Sundaram**, put forth policy messages in key areas:

Domestic resource mobilization: Investment is key and is the essential trigger

One key assumption in traditional thinking about the relationship between savings and investment is the creation of incentives for raising domestic savings. But now there is greater recognition that the key issue is raising investments, with savings (and finance) following investments, instead of expecting savings to lead investments. In this context, public and private investment should be looked at as complementary and not as crowding out each other.

Governance: The emphasis given to governance may at times be overstated
A rethinking is needed with respect to the relevance of governance indicators in the debate on good governance in economic development. The orthodox view now seeks to strengthen property rights. But there is a great deal of evidence that some developing countries have been successful in creating effective incentives, despite ill-defined property rights. There is a growing understanding that many people do not resort to contract law and that the requirement should be governance that is good enough.

Policy Space: **Serious deliberations needed on what constitutes national ownership**
At UNCTAD XI (Sao Paulo, 2004) there was a commitment to try to expand policy space in line with a greater commitment to 'national ownership'. Mr. Sundaram called for serious deliberations about what this means in terms of true national ownership. There is much to be done in the year ahead as part of the preparatory process for Doha 2008.

Private Capital Flows: Recognition of their limitations necessary
There is no evidence that the recent increase in capital flows to developing countries was due to financial liberalization, which in fact took place during the preceding period. As

Ken Rogoff's and others' research suggests, financial globalization has not contributed to economic growth, but instead has exacerbated volatility and instability.

Foreign Direct Investment: Some aspects of FDI need a re-think
According to the 2000 World Investment Report, 80 percent of FDI in the 1990s was composed of Merger and Acquisition (M&A) activity. Rethinking is needed with respect to regulatory competition on investment, as there is evidence that there has been no trickle down effect of FDI on local economies. In **Sub-Saharan Africa, FDI** is mainly associated with natural resource extraction. Attractive terms often become outright subsidies. A rethinking has taken place on the so-called "resource curse" and "Dutch disease" as we have learned how to help reduce the economic volatility associated with resource prices and to better manage the macroeconomic impact on the domestic economy.

Food prices: recognition needed of the heterogeneous impact of food prices on poverty
The significant increase in food prices worldwide has not only important implications for food security in developing countries, but also raises the question of whether developing countries have really profited from high commodity prices in recent years. As Rodrik has recently stated, we can avoid much confusion in the debate on the benefits of international trade by recognizing the diverse and heterogeneous effects that food prices have on poverty around the world. The impact depends on whether one is a net seller or a buyer of food, as well as on supply elasticities. A comprehensive analysis should also include trends in commodity terms of trade and in terms of trade of manufactured goods from the Global South.

Aid effectiveness: Predictability of aid flows is a problem
The Paris Declaration on aid effectiveness presents a milestone in development cooperation: however, many developing countries were not part of the negotiations. The Declaration in particular does not appropriately address the predictability of aid flows. The Development Cooperation Forum and Accra Conference are important events at which this issue can be addressed.

Climate change: Issues in the South
The current debate on climate change does not adequately address the specific needs and national circumstances in developing countries. The approach of the IMF on carbon taxation ignores regressive implications and the distributional impact of such an instrument on the poorest citizens in the Global South. Equal universal carbon tax as recommended by the Fund would not create a level-playing field. All major schemes of climate change mitigation would have regressive implications. It is important to design policies that do not exacerbate this regressiveness.

Bretton Wood Institutions: **Governance an unfinished agenda**
The governance structures of the International Monetary Fund and the World Bank need to be reformed in order to ensure effective participation of developing countries in their

decision making processes. The new voting formula that was recently decided by the IMF Board is fundamentally flawed.

Financial crisis: The need for a better regulatory framework

There is a serious predicament in the international community which impedes (or hinders) fully grasping and resolving the current financial turmoil. Short-term policy solutions may not be sustainable, and there is an urgent need for a better regulatory framework for the long term. Debt issues to be discussed here were enriched by the concept of debt sustainability with growth and development. The issues are relevant for the preparations for the Doha Review Conference.

The second speaker, **Roger Kubarych**, covered the issue of securitization, which is at the heart of the subprime mortgage crisis.

Securitization: Regulatory practices key for success of securitization

In Roger Kubarych's view, while the securitization of financial assets can be beneficial to economic development, prudent financial supervision and regulation are a prerequisite for well functioning financial markets. He explained that securitization in the United States was initially driven by government sponsored enterprises and backed by high quality mortgages. After these public enterprises overexposed themselves with mortgages in their own portfolio and lost public trust due to increased risk exposure, the private sector took on a leading role in home mortgage financing and securitization.

While privately securitized mortgages as a share of overall mortgage financing in the U.S. increased from 7.5% in 2000 to 19.8% in 2007, the financial regulatory system was ill-equipped to tackle abusive lending practices. Moreover, poor judgments and conflicts of interest exacerbated the speculative housing bubble.

Lessons on securitization for emerging economies

- Emerging market countries with large holdings of assets in global capital markets should seek to minimize their risk exposure by relying on market analysis from independent financial experts (not by ratings agencies).
- Countries with current account deficits (net recipients of flows) should diversify their sources of funding with a special commitment to attracting private equity capital.
- The domestic banking sector should be allowed to provide credit without politically-motivated directives.
- Prudent financial supervision and regulation have to be established and the oversight of risk-taking and financial health of domestic banks should be exercised by the central bank.
- In order to benefit from securitization of mortgages and commercial loans, it is a prerequisite that a financially capable buying side is in place that has the capacity to evaluate the underlying risk of securitized instruments. Institutions with the capability to carry out such risk evaluations independently are insurance companies, pension funds and other financial institutions.

M.V. Leeladhar, the third speaker, presented the Indian experience with CAL to illustrate some lessons in opening and managing the capital account.

Capital account liberalization: Lessons from the Indian experience

The main elements of external sector policies in India are: (a) maintenance of an acceptable level of current account deficit, (b) market determined exchange rate regime, (c) building up reserves by encouraging non-debt creating flows and de-emphasizing debt creating flows, particularly short-term debt, and (d) creating an enabling environment for foreign direct investment.

Active capital account management has been exercised by the central bank in order to avoid the negative impact of the substantive increases in capital flows such as large domestic liquidity movements and the consequent distortion of market exchange rates and interest rates. The policy instrument of interest rate increases to sterilize excess liquidity has had a limited effect, as it does not only pose a risk to economic growth, but also increases the possibility of further capital inflows. While it is necessary that banks hedge their exposures to currency and interest risks associated with sudden reversals in financial market sentiment, more durable policy responses by the government are necessary for enabling the absorption of capital flows into productive capacity. Capital outflow liberalization is a limited short-term policy instrument, since such a regime attracts more capital inflows. The active management of the capital account requires a conscious choice in terms of a hierarchy of capital flows. In this context, long-term capital flows are generally preferred over short-term capital flows. In the face of large capital flows the exchange rate policy of central banks should be guided by the principle of careful monitoring and flexibility in the management of exchange rates without deciding on a fixed target or pre-announced target or band, coupled with the ability to intervene if necessary.

Roy Culpeper, the fourth speaker in the first session covered some additional issues relevant for the Follow-up to the Monterrey process.

Growth: A key issue – how can growth be sustained?

Since Monterrey, growth performance in developing countries has been remarkable particularly in Asia, driven by trade and investment. One key question for the Doha Conference will be whether current economic growth path can be sustained and how?

Climate change: how will additional resources be mobilized?

It is especially the poorest countries, that are least to blame for the problem, that will be affected by climate change, which may result in large scale environment migration. The associated adaptation and mitigation costs of climate change are going to be very high and more than what the aid system can manage. A key question will be how additional financing can be mobilized?

Financial crisis: A failure of the International Financial System

The failure of the international financial system to bring down global imbalances indicates the urgent need for reform of the international financial systems. The timid moves towards improving multilateral surveillance have not yielded results. The impact on the real economy is still unfolding.

National development strategies: How will each chapter of the Monterrey Consensus support National Development Strategies?

One fundamental question for developing countries with regard to the Doha Review conference will be how each chapter of the FfD Outcome Document will support and enable domestically owned development strategies in the Global South. For example, how can foreign direct investment, which is heavily concentrated in natural resource extraction, be shifted towards investments which meet domestic and regional needs? The fact that FDI is often detached from other sectors of the economy is an area of concern. New development strategies are necessary for the mobilization of additional investments to address the huge need for infrastructure development in developing countries.

Trade: A new trade regime needed

The "WTO development round" has reached an impasse, which should open discussion for a re-visit of fundamental rules and assumptions of trade relationships, including asymmetries and a new trade regime that allows for asymmetric trade rules favoring developing countries.

Official Development Assistance: **Moving away from aid dependency and conditionality**

ODA should support nationally owned development policies. Therefore, strict conditionality and tied aid policies should be replaced by budgetary support for developing countries. Care needs to be taken as there is evidence that budgetary support leads to macroeconomic conditionality. Nationally owned development strategies should overcome the current constraints and incorporate exit strategies from aid dependency. The Accra Conference on aid effectiveness can play an important role and new donors such as China and India should be brought to the table.

Debt relief: A new mechanism is needed

A new mechanism beyond Paris Club is needed to take into account new creditors.

Recommendations from Discussion:

- A policy response to the challenge of climate change has to be internationally coordinated. The debate should not only narrowly focus on economic aspects and the role of technology, but rather on equity. If the production of bio-fuels were internationally coordinated, the use of inefficient food grains for the production of ethanol could be limited.
- In order to support the concept of nationally owned development strategies, international cooperation on tax matters has to be given more political legitimacy.

- Policy approaches towards an inclusive financial sector have to go beyond the concept of Microfinance. This would require financial sector development that provides financial services for all groups in the population, in particular the poorest citizen.
- The main policy tool of the IMF for the management of capital flows is aggregate demand as opposed to interventionist polices. This needs a re-think
- The recent cutbacks in the joint Financial Sector Assessment Programs (FSAPs) of the IMF and World Bank are surprising in the context ot the global environment, where there is a renewed emphasis on regulation.
- The international trade regime has to ensure that latecomers can follow their own development strategy.

Session II: Emerging Global Issues in Financial Integration

John Williamson: Crises and International Policy Coordination

The emergence of the credit crunch has given global imbalances a new quality. Emerging markets will not be immune to the US slowdown and will have to adopt expansionary policies. If surplus countries like China exercise a policy shift from export led growth to expanding domestic demand, this could lead to a crisis of confidence of foreign investors in the US economy, coupled with a further collapse of the US Dollar and thereby heading off to an unwinding of global imbalances. However, it is gratifying that financial turbulences to this point have not been associated with a loss of confidence that brings a major fall of investment in the United States.

Williamson argues that the prime responsibility for the financial turbulence is to be found in inadequate supervision. The authorities welcomed the process of securitization and its corollary, the originate-to-distribute model, without adequately weighing the dangers they inherently bring in terms of increased susceptibility of the financial system to crisis. Strengthening financial regulation on a global level is needed for avoiding future crises. Furthermore, macroeconomic policy coordination is necessary to limit global imbalances and the Yen carry trade.

It is desirable that any changes be introduced essentially simultaneously in all the major financial markets; otherwise there is the danger of the benefits of reform being lost due to regulatory arbitrage. If that is classified as policy coordination, then coordination is central to achieving a more robust system. The more traditional form of coordination, in which the authorities of the leading countries commit themselves to pursuing a mutually consistent set of macroeconomic policies, remains of some importance. The yen carry trade is one of the factors that contribute to the danger that this system ends up in crisis, and it would be addressed as well as seems feasible by a system of traditional-style policy coordination.

Avinash Persaud: Adequacy of International Reserves:

Persaud argued that it is only by changing incentives in the financial system and the regulatory framework can we prevent future crises. The Basle regime has fundamental flaws. It puts market prices at the center of focus and looks at risk to be taxed, forcing risks to move to another area where they cannot be seen. We need to leave risks visible and regulators should use risk-modeling. The banking sector is privatizing returns but socializing risks and influences policies and regulators.

Most small open economies prefer fixed exchange rates. In emerging markets two-corner exchange rate solutions have been dropped in favor of more reserves, coinciding with strong growth, thus providing liquidity insurance to financial markets. Sovereign wealth funds are very different from reserves, which were mostly used for exchange rate crisis management. Indian reserves have risen eight fold while imports have doubled. But financial integration was fast advancing, requiring reserves against short-term outflows.

India's reserve position is much healthier if the market valuation of equities is taken into account. Short-term debt was key in recent crises. The situation with equity is very different. If equity is issued to finance a firm, risk is on shareholders, but exiting equity portfolio flows also cause pressure on a country's exchange rate. Data suggest that equity is less volatile than short-term debt and now plays a key financing role. We have had a long period of equity investment, but no longer dedicated, rather equity investments by cross-over investors. However, equity value is more volatile. The biggest problem today is that emerging markets are not any longer dominantly exposed to short-term external debt, but rather to cross-border equity based capital flows. While portfolio equity flows like FDI have been characterized as long-term investments, financial liberalization and innovation has undermined this distinction. Investors can borrow against illiquid, long-term liabilities and create liquid short-term counterparts.

The level of foreign exchange reserves is hardly excessive for most emerging market economies. By taking into account financial liberalization and innovation in determining risk for developing countries, we come to quite different conclusions when determining the appropriate level of reserves. If we calculate the ratio of foreign exchange reserves to sixth months of imports plus external liabilities, using smoothed market prices and excluding FDI, we will find that for most emerging countries the level of reserves are not excessive.

Discussant: G.M. Milesi-Ferreti, was of the view that global imbalances were not the driver of current financial turbulence. He argued that valuation changes played an important role. The United States has liabilities in domestic currency and assets in foreign currency. The depreciation of the dollar and underperformance of stocks thus have their consequences for the world. He agreed with Williamson on his analysis of the yen carry trade.

Multilateral consultations were not received with enthusiasm, especially in Asia because of past perceptions of the IMF. Securitization was really designed to shift risk to those who can bear it but did this did not work that well. Emerging Europe is catching up, but with rising debt versus reserves build-up in other emerging markets, especially in Asia. FDI and portfolio equity liabilities are rising everywhere as percentage of GDP. Milesi-Ferreti questioned the validity of traditional indicators of reserve adequacy with the changing nature of vulnerabilities and risks.

Discussant: J.A. Ocampo agreed with most of Williamson's analysis but disagreed with some of the recommendations. The wealth effect of dollar depreciation is borne by the rest of the world and is more important than Williamson indicated. His strong remarks about securitization belittle its benefits for development of debt and mortgage markets as in Chile. His view of the financial market is one of strong procyclicality. Regulation can offset it, but marking to market exacerbates it. The third issue is overleverage of a systemic character while some of the innovations were for evading the need of more capital. These are major problems facing financial regulation.

Debt insurance does contribute to global imbalances as costly individual defense versus collective insurance. Volatility of equity flows can be quite high and has an indirect effect on prices of domestic assets adding to procyclical flows.

Session III: Issues in Public Debt Sustainability and Debt Management

Jose Antonio Ocampo and Camilo Tovar: External and domestic financing in Latin America: developments, sustainability and financial stability implications

Latin America witnessed unprecedented growth, which has come along with a major change in financing patterns. A favorable macroeconomic environment in Latin America, characterized by economic growth and current account surpluses, sustained capital flows mainly in the form of FDI has improved the region's international investment position and reserve accumulation significantly, thereby strengthening the region's capacity for self-insurance. It has also led to a shift from cross-border to domestic financing and, domestically, from bank to bond financing. As a result, domestic capital markets have expanded, deepened and diversified much further than was expected, and have been regarded as a sustainable financing alternative. These developments have helped in partly overcoming what in the literature is known as the "original sin".

Such developments have helped mitigate risks and sources of vulnerability by reducing balance sheet exposures and systemic instability associated with currency mismatches, as well as by providing an alternative source of financing when banking sectors are weakened. As a result, markets have strengthened the stability of local financial systems.

However, their rapid development is also a potential source of risk as many potential sources of instability need to be assessed such as:

- changes in currency composition and its implications for the maturity structure of debt,
- illiquid markets,
- narrow domestic investor base and

- lack of a proper infrastructure and regulatory framework. These are all potential sources of instability that need to be assessed.

Thus, the development of local currency debt markets has led to progress in the reduction of currency mismatches, but these markets are nevertheless characterized by short-term biases and have not solved problems of market liquidity (low level of secondary market trading). It remains to be seen if the progress made so far will make the region better prepared for a more prolonged turmoil in global financial markets and will provide leeway for countercyclical macroeconomic policies. The development of large and deep markets for corporate debt remains unfulfilled in most countries of the region. It is an area which would require a structural policy response.

Heiner Flassbeck and Ugo Panizza: Debt Sustainability and Debt Composition

While the debt situation has improved considerably in developing countries, the high level of self-insurance is an indicator of shortcomings in the international financial system. Vulnerabilities exist in particular with respect to a lack of debt indicators that take into account both the level and composition of debt. Most debt sustainability analysis mixes the concept of external sustainability with that of fiscal sustainability.

There is still confusion with regards to the clear definition of fiscal sustainability and the benchmarks which need to be met which would define a country's policies as fiscally sustainable.

There are three key lessons which have been emphasized that need to be taken into account while analyzing external sustainability:

(i) Calculations of government debt sustainability may be misleading and analogies used to evaluate the former should be discouraged from use.
(ii) *Foreign debt* as a result of negative exogenous shocks is *never sustainable* (other than when a future positive shock of equal magnitude is expected).
(iii) A thorough analysis of *causes of indebtedness* should be executed while measuring sustainability needs. It should be noted that analysis based upon debt levels and forecasts of some macroeconomic variables lead to highly inconclusive results.

While developing countries have made progress by shifting debt from cross-border to domestic financing (e.g. Bonds in domestic currency) and to financial instruments that could limit cyclical vulnerabilities (GDP indexed bonds), there is an urgent need for domestic debt to be included in Debt Sustainability Analysis in order to account for new vulnerabilities.

Better data are necessary because debt sustainability analysis should focus on total debt and study the implication of the debt structure. A better analysis would take into account data on the composition of debt (maturity, currency, type of holders) and build an aggregate debt ratio where riskier types of debt have a higher weight than safer types of debt. The main obstacle to conducting such research is data availability.

The empirical analysis comes to the conclusion that when comparing external public debt with private creditors in foreign currency, domestic public debt and external public debt with official creditors, the first is associated with the highest risk, while the latter with the lowest.

Tomas J. Balino and V. Sundararajan: Public debt management in developing Countries: Key Policy, Institutional and Operational Issues

The World Bank and the IMF have made important efforts over the past decade to develop public debt management guidelines, which are taking into account the different degree of development in member countries and are meant to assist developing countries to reduce borrowing costs. While it is common practice for OECD countries to have a published debt management strategy, a recent survey of developing countries conducted by the World Bank found that only half of the sample countries had such a strategy and that publication of the strategies was even rarer.

The structure of public debt has changed significantly in a number of emerging market economies, due to significant debt restructuring operations over the last years. In an environment of high liquidity and low interest rates, emerging market economies have reduced their external liabilities and have domestic financing substituted for foreign debt. Additionally, more than 20 emerging market sovereigns have taken advantage of financial innovation and changed their debt profiles by arranging for swap credit lines with international banks.

In low-income countries foreign debt was significantly reduced by debt relief initiatives. However, due to the lack of adequate transparency practices and coordination between the different debt agencies in most of the HIPC countries, debt management has actually worsened. It would be important to provide additional technical assistance for this group of countries to improve their debt management capabilities.

Asset-liability management (ALM) is a key instrument in debt management for analyzing risk and cost trade-offs. However, modeling costs and risks using ALM are complex and only very few countries have so far begun to work with this framework. Therefore, a simpler approach, focused only on certain assets and liabilities may be more attainable for the majority of countries.

While country ownership is important in public debt management, the international community can encourage and support countries in applying WB/IMF guidelines in public debt management. However, it is important that the application of guidelines does not lead to a distortion of priorities, as it will not always be optimal for developing countries to devote all resources needed to obtain perfect scores in assessment.

Discussant: Martine Guerguil

The financing patterns in low-income countries are quite different from those in more advanced countries. While the share of external financing has increased (between 4-10% of GDP over the last years), they originate mostly from private sources and are predominately in the form of non-debt flows (FDI and remittances).

Trends in official flows show a strong shift to grants and increased diversification. The latter is in particular caused by the entrance of new creditors from emerging countries, mostly in natural resource extraction. China is predominately using future profits as collateral for investments.

While there is an absolute increase in domestic debt in low-income countries, the total share of these debts to GDP has declined. Countries are experiencing an increased participation of foreign investors in domestic bond markets. Given, that the share of foreign investors in domestic bonds in some LICs has reached 20%, this may create new vulnerabilities that might be difficult to assess.

The shift from public to private sources of financing and the associated volatility of these flows require increased regulatory supervision in low income countries. While the risk of default on domestic debt is quite different from external debt, they may interact. Unsustainable domestic debt levels may have an impact on external debt; in particular as increasing foreign participation in domestic debt instruments increase risk.

Session III: Sovereign Debt Restructuring

Benu Schneider: Clubbing in Paris: Is Debt Sustainability an Illusion?

Official debt restructuring poses numerous challenges. A new debate is emerging on the reform of the official debt restructuring mechanism as a result of the increase in contributions by developing countries in funding development in the South. In addition, the growing importance of private debt in total external debt poses new challenges for the Paris Club, which requires its debtors to seek comparable treatment from other creditors, including private creditors. Strains are visible in implementing this principle as debtors are handicapped by the lack of legal status of Paris Club agreements.

The paper draws on the lessons from the experience of rescheduling at the Paris Club. Schneider focused on the problem of serial rescheduling for many of the countries coming to the Paris Club and was of the view that the problem reflects a gap in financial architecture. In cases when solvency problems are treated like those related to liquidity, the original problem is compounded because of short consolidation periods and old cut-off dates, as well as mistakes in projections of the IMF and "snowballing" debt because of bunching of repayments due to relatively long grace periods, market interest on non-ODA rescheduled amounts and new credits after rescheduling. In this regard, the “short leash” approach not only means debtor governments require serial rescheduling at the

Paris Club, but also that they do not move their respective countries towards a sustainable debt level.

Schneider pointed to the role of IMF in Paris club rescheduling and explained the conflict of interest for the Fund. There is no compatibility between the role of the IMF as gatekeeper for concessional resources and, on the other hand, as creditor and therefore a stakeholder in the inflow of the same resources. Debt relief often is used to finance fund programs and/or finance development expenditure. The author asks whether Paris Club members can finance development through more efficient channels than through Paris Club debt relief operations. For this, the pros and cons of using Paris Club procedures for financing development expenditure in countries that do not have an existing debt problem need to be understood. A comparative cost-benefit analysis with other sources of finance is needed.

Technical expertise provided by the Fund on forecasts of growth and exports have proved to be overoptimistic and resulted in an early return of countries to the Club for a re-rescheduling. The practical analysis of debt sustainability is highly important, heightening the need to critically assess the current approaches to assessing debt sustainability. In addition, preliminary results examining financial market views of the impact of a Paris Club rescheduling showed that Paris Club agreements negatively affect spreads. The Paris Club rescheduling is seen as a signal of debt distress and impacts spreads and future costs of borrowing from the private sector.

The technical work to support official debt restructuring needs to go beyond models based on those applied by the private sector that give exclusive priority to assessments of liquidity situations in countries affecting their debt servicing. More transparency is needed in official debt restructuring operations to include information on interest rates, the list of debts covered and penalty costs. A simplified process is needed so that the Paris Club negotiation and bi-lateral negotiation process can be merged into a single process.

Christoph Paulus and Steven Kargman: Beyond Collective Action Clauses

The introduction of full-fledged statutory debt restructuring mechanism for sovereigns seems unlikely for the present time. It appears preferable to concentrate on the introduction of certain of component parts of a statutory mechanism proposed by IMF. The introduction of a dispute resolution panel might be the most appropriate first step. While bringing some structure to a sovereign default, CACs cover only the creditors and not also the sovereign debtor.

The authors recommend an arbitration tribunal as the way forward in debt restructuring. The arbitrage tribunal, comprised of a small number of high-profile panelists, should be established under the auspices of a multilateral institution which is not a lender institution to sovereigns. At present, the UN appears to be the most appropriate candidate.

Any such authority will be dependent on the prior contractual agreement to arbitration by all of the relevant parties. The introduction of an arbitral tribunal will depend on a pre-crisis consensus among the parties. This makes it critical to include an arbitration clause in each respective issuance of sovereign bonds – similar to the inclusion of CACs. The tribunal will not have any intrinsic authority to initiate and decide cases on its own. At a minimum, the tribunal should be empowered to address matters related to the verification of claims as well as voting issues related to the approval of the restructuring plan and other similar matters. Binding effect extends only to those creditors who have agreed to subject themselves to arbitration by signing the contract containing the arbitration clause.

The relevant trigger for invoking arbitrage mechanism is the announcement of a default. The creditors would have to develop and specify a mechanism for creditor representation. Mediation could be the precursor to a binding arbitration procedure. Financing and support for the tribunal should come from the sponsoring organization.

Discussant: **Anna Gelpern**, **A**ssociate Professor of Law, Rutgers School of Law-Newark, The State University of New Jersey, Newark

- Debt resolution decisions should be taken out of IMF because of stringent economic and political conditionalities.
- Standing dispute resolution mechanism (tribunal) could be a step towards a more ambitious regime.
- The 2003 Security Council Resolution on Iraq debt stated that the oil resources were immune to any kind of attachment. At the time IMF was proposing its debt-restructuring model for developing countries, which in turn was seen as too intrusive by market participants. This resolution reflects all the problems of the current mechanisms and the two papers focus on offering better alternatives. Steve's proposal could become an ambitious and permanent solution to many of the problems. Still the resolution of possible debt of countries stuck in a permanent receivership or with the so-called "odious" debt would be very different.
- There should be more research of domestic debt contracts.
- Concerning the tribunal, building institutional credibility is key.
- Dealing with vulture funds should be seriously discussed.

Session IV: LICs' Access to Finance

Farhad Noorbakhsh, **Luis Angeles**, and **Celine Azemar:** Selectivity and aid allocation: is there an improvement?

The paper analyzed the behavior of donors over the period 1984-2003. It tests whether there has been a change in the behavior of donors since the late 1990s (since the HIPC initiative) and if aid has become more selective. The econometric analysis examines three types of determinants, recipient country needs, recipient country merits and the interest of donors.

Some of the findings of this study are that commercial partners, ex-colonies and countries with a special geopolitical situation tend to receive more aid. Since the late 1990s foreign aid has become more focused towards poorer countries. At the same time, bilateral trade has become less important as a predictor of foreign aid flows.

There is no evidence that democratic regimes attract more aid than they used to or that countries that achieve low inflation rates are better regarded than those that do not. In other words, there is no strong trend towards selecting countries with good policies and institutions.

It thus appears that the neediest and most meriting countries receive more aid, emphasizing positive selectivity of donors for the observed period. Post 1998, there is a change in donor behavior. The World Bank is the donor that has the most important improvement in terms of aid selectivity after 1998. The authors find a clear improvement in poverty selectivity which is accompanied by a decrease in commercial interests. On the other hand, aid does not become more selective with respect to democracy and inflation but the authors do not find an increase for some donors in their aid responsiveness to the quality of recipient country institutions.

Aziz Ali Mohammed: The IDA Deputies: A Governance Issue

Deputies of the International Development Association (IDA), as part of the IDA structure, have no legal status in the IDA Articles of Agreement and yet appear to play a decisive role in the formulation of policies and processes relating to IDA activities, including the conditionalities attached to IDA grants and credits.

The intent of IDA founders was clearly to ensure that recipients would have, and would maintain, a very substantive participation in all IDA decision making. Voting power in IDA has two components: membership votes which are allocated to all members equally and subscription votes, which vary with the amount each member has subscribed.

The relative voting power of the Part II[4] countries is maintained by allocating subscription votes to them at a nominal cost of one vote for each $25 subscribed while membership votes are conferred without additional charge when subscriptions are made. It allows the Part II block to hold about 48 percent of total IDA votes and their share would have been fully protected through the successive replenishments. This intent, however, has been subverted by the exceptional influence gained over the years by the IDA Deputies and by the failure of all Part II members to take up their allotted shares.

[4] The Part I and Part II classification is based primarily on economic standing. Part I countries are almost all donors to the International Development Association and pay their contributions in freely convertible currency. Part II countries may be donors, and are entitled to pay most of their contributions in local currency. For more information, and for Statement of Voting Power, and Subscriptions and Contributions of IDA Members, see The World Bank Annual Report 2000: Financial Statements and Appendixes to the Annual Report .

The author suggests that emerging economies should not only come up with their own IDA subscriptions but also help LICs pay for their allocations in the framework of South-South solidarity. The increased voting power of developing countries in IDA might also help reduce industrial countries influence in areas where IDA works closely with the IMF, but where the voting structure is much less favorable to LICs. In addition, the World Bank management should restrict negotiations with donors to the overall contours of a forthcoming IDA replenishment, including its aggregate size and also seek agreement on a key for its distribution (as a percentage of GDP in PPP terms) instead of burden-sharing becoming a contentious issue during negotiations.

Ajit Singh: Stock market development in low-income countries
The paper explored whether the institution of the stock market is likely to be helpful to developing countries in promoting development of their real economy and ensuring fast industrial growth. The answer is No, according to the author. He is critical of the International Financial Institutions' (IFIs) preference for the Anglo-Saxon model of corporate governance, based on what they regard as "best practice", and agrees with the critics' conclusion that the stock market engenders short-termism and quick financial gains rather than long-term investment, which is inimical both to competitiveness and fostering economic development. The dominance of stock markets can result in the unhealthy ascendancy of finance over production.

Small, poor developing countries at their current stage of development should focus on reforming and improving their banking systems rather than on encouraging the establishment of stock markets. Indeed most markets remain 'immature' (i.e., riddled with insider trading and lack of transparency) and relatively illiquid. Developing countries have found it difficult to regulate stock markets, as is indicated by frequent scams on stock markets. Moreover, market volatility is further accentuated if countries allow external portfolio capital inflows.

It is unlikely that small African national exchanges could survive by joining together regional stock exchanges, largely due to the fact that there are big differences between countries with respect to law, custom, working culture and accounting standards.

Developing country corporation's reliance on external finance is far more than those in developed countries, and within external finance they utilize equity finance to a surprisingly large degree. It is unlikely that a greater influence of the stock market would lead to an improvement in corporate governance and corporate performance.

One, particularly useful regulatory reform for developing countries would be to stop the creation of a market for corporate control, as such a market encourages short-termism which is detrimental for economic development. Developing countries should encourage product market competition to discipline corporations rather than rely on the stock market for this purpose. In developing countries share price and external portfolio capital flows volatility greatly increase the vulnerability of the economy to international and domestic shocks.

To sum up, this paper concludes that stock markets may be potent symbols of capitalism, but paradoxically capitalism works as well, if not better, when stock markets do not have a major role in the economy and this is the main lesson from the perspective of economic development in emerging countries.

Discussant: Rob Vos

Aid allocation analyses have never been very convincing. In aid allocation, so-called band wagon effect (donors provide aid to the country because other donors do so due to IMF approval) should be taken into consideration. In addition, institutional quality is not always a factor: donors provide assistance to fragile states to help them move forward.

Stock markets help mobilize resources in developing countries. At the same time there is no clear correlation between stock market development and mobilization of savings. Stock market capitalization should be at least $50 billion to attract foreign portfolio investors. Company size is also a factor. Complementary role of stock markets in financial development is improving firm transparency.

More attention should be given to bond market development and strengthening the banking sector.

Session V: Some Issues in LICs

Layna Mosley: Regulatory choices for low-income countries in a world of financial integration

This paper documents the extent of capital account liberalization in selected African countries and the state of their regulatory practices. Due to a low level of correlation of African markets with other markets, private capital has been moving to sub-Saharan Africa as well and the level of legal openness has increased. As far as the regulatory environment is concerned, an evaluation of the Reports on Standards and Codes show that sub-Saharan Africa nations face many challenges to develop their banking sectors and capital markets, managing public debt, and regulating and supervising financial institutions. Many of the assessed countries may thus not be ready for full liberalization.

LICs should focus on how to attract investors with longer time horizons. This may require property rights, judicial system and corporate governance reforms. The central goal should be achieving regulatory and political preconditions (data collection, well-developed regulation and supervision, etc.) that will allow recouping positive benefits of capital flows. There is no “one size fits all” means of assessing countries’ preparedness to take advantage of the global capital markets. It is unlikely that the same mix of cautious closure and global engagement is appropriate for each country

The data available from Central Banks in Africa is incomplete. LICs’ financial regulators should develop a more accurate picture of capital flows, including an assessment of the extent to which capital account restrictions are effective in practice. LICs should maintain an awareness of capital flows volatility and devote effort and resources to the establishment of debt management offices. The debt should be managed with an eye toward sustainable levels of borrowing.

Aldo Caliari and Manuel Montes: The interaction between market access, debt relief and aid

This paper sought to shed light on the types of issues that tend to fall through the cracks between the Monterrey chapters. It takes the linkages between aid, debt relief and market access to illustrate this point and makes a case for a holistic approach to financing for development.

For example, Aid for Trade is a multi-chapter issue in terms of the Monterrey framework and it has the potential of being a pilot process in exploring the interactions between Monterrey chapters on Aid, Trade and External Debt. The paper explores the different dimensions of the concept of Aid for Trade and explains its impact on debt. It argues that Aid for Trade should be embedded in development policies. Employment generation and infant industries should take precedence over market access.

The inadequacy of existing compensatory mechanisms for trade can be interpreted as a generator of debt vulnerabilities. To be adequate, it will be necessary to reconsider the conditionality requirements to provide financing for shocks that are outside the control of affected countries. In the current situation of higher food and energy prices, the absence of adequate import financing facilities is particularly critical. A French instrument for countercyclical intervention sets a precedent that could be considered in relating debt servicing to trade shocks. Compensatory financing will diminish automatically with export diversification and a move up the value chain. Uncertainties about concessional and contingency financing seriously hinder trade strategy in general and investment that may be oriented to exports in particular. Sustaining capital accumulation towards upgrading and diversifying economic activities should be the aim of development financing.

In the area of debt relief, the actual impact of debt service on the ability of the country to establish the conditions for trade-led growth is not a consideration in determining eligibility and amounts of debt relief. The staff of BWIs do not have a framework to disaggregate their own responsibility for policy advice to borrowing countries and the policy decisions of borrowing countries themselves.

The Debt Sustainability Framework is meant to inform a borrowing strategy and set prudential limits on non-concessional and concessional financing, but has inadequate provisions for the financing impact of external shocks. It overemphasizes the role of CPIA in debt sustainability and misses out on crucial variables for debt sustainability assessments.

Discussant: B. Guha,
Guha noted that capital account opening and its regulation in Africa is very well described in Mosley's paper. The effect of financial development's on economic development can be positive or even negative, according to literature. Even FDI flows do not necessarily lead to long-term growth. For instance, NAFTA has led to skilled labor emigration from Mexico.

The potential of capital flow reversal goes down only if flows are committed over the long-term to the country. It is unfair to expect developing countries to subscribe to international standards handed down by developed countries. It makes sense to look deeper into local practices before trying to change them. The challenge of the impossible trilemma can shed light on the cautious approach adopted by countries such as China and India.

In the second paper, the authors chose two ways to tackle the linkages. Aid for trade is a second best argument, policy coherence is more important. The donor community should look for ways to embrace all three objectives the authors proposed for aid for trade, with possible sequencing of policy measures. Export diversification and moving up the value change is a preferred option for resolving the tension between debt, aid and market access.

Jomo Kwame Sundaram: Concluding remarks

It is appropriate to have a distinction between global imbalances and the economic and financial crisis. It is also clear that the response to the crisis needs to be multilateral and coordinated. There is no alternative to IMF. That is why its governance reform is so important.

Unlike in the 1970s-1990s, much of developing country public debt is now domestic debt. In this respect, tax cooperation is important. Sovereign debt restructuring machinery debate needs to be revisited. Tribunal may provide a more flexible mechanism.

As for ODA, specific challenges for IDA commitments are important while conditionalities are a matter of concern. Aid for Trade and financing for climate change mitigation and adaptation are among new issues.

Stock markets represent challenges for both MICs and LICs (vulnerabilities, knock-on effects). Increasingly people are talking about capital account management and not capital account liberalization.

In Doha we must build on a great deal of new knowledge accumulated since Monterrey.

Some of the policy messages that emerged from the presentations and discussions that are relevant for policy reform in promoting financing for development and a stable financial system are:

1. International policy coordination is needed to deal with global imbalances and carry trade
2. Securitization is risky if institutions are not in place. Regulation and supervision of this segment should be with the central bank.
3. The risk models taken over from a private investment bank by regulatory authorities are adequate for an individual firm but not suitable as a tool to capture systemic risk. Basle II failed to pick up the risk during the sub-prime mortgage crisis.
4. In evaluating the adequacy of international reserves, equities should also feature in the liability side on which adequacy is being judged.
5. There are limits to the advantages of Foreign Direct Investment (FDI). There is evidence that mergers did not increase profitability and acquisitions did not increase savings.
6. Strengthening and improving the banking sector in low-income countries is the first priority. The benefits of capital market development in their current stage of development are limited. There are benefits to sequencing bond market development before stock market development.
7. Market liquidity puts limits on the resources that can be raised through local currency bond markets.
8. A re-thinking is needed on how to reform the debt restructuring framework and technical work on debt sustainability frameworks. Existing approaches to debt restructuring mechanisms suffer from setbacks calling for mechanisms with a legal basis.
9. There are risks in current account surplus economies too, where in spite of domestically available resources, banks and corporations borrowed from international markets increasing international liabilities.
10. Debt sustainability frameworks need to be reviewed and the links between debt management and debt sustainability need to be better understood.