General Assembly
Ad Hoc Open-ended Working Group to follow up on the issues contained in the Outcome of the Conference on the World Financial and Economic Crisis and Its Impact on Development

Fourth meeting on
"Access to credit and concessionary finance; fiscal space for countercyclical policies; and the current global reserve system"
(New York, 30 April 2010)

Informal summary by the Secretariat

Overview. The meeting was co-chaired by H.E. Mr. Lazarous Kapambwe (Zambia) and H.E. Mr. Morten Wetland (Norway) who introduced the theme of the meeting, which was based in particular on paragraphs 12-14, 16-18 and 35-36 of the Outcome Document, with the focus on assessing new lending facilities from international financial institutions in response to the crisis, concessionary finance, the modernization of conditionalities and other issues related to global liquidity and financial stability, including the use of Special Drawing Rights (SDRs) and the current global reserve system. The presentations and discussion also addressed the extent to which developing countries had regained access to credit from private sources and the key obstacles they had faced at the national and international levels in seeking the fiscal space to enact countercyclical policies.

Summary of the presentations by the panelists

Mr. Daniel Titelman, Chief of Development Studies Section of the Economic Commission for Latin America and the Caribbean (ECLAC), in his presentation addressed access to international financial flows in Latin America and the Caribbean. He noted that although during the period 2003-2007 LAC economies experienced good macroeconomic performance, the global crisis caused one of the most severe declines in GDP in over three decades and the sharpest episode of growth deceleration since the 1980's. The good news was that the combination of policy activism and more favorable external conditions was expected to support a rebound in LAC economic activity in 2010.

He noted that some countries announced increased fiscal spending for 2009, but not all had the same financial and fiscal institutional capacity to adopt counter-cyclical policies. This reflected the heterogeneity of the region and underscored the need to increase institutional capacity and help in financing countercyclical policies.

He added that all types of international financial flows - portfolio, foreign direct investment (FDI) and remittances - to the region experienced a significant reduction as a consequence of the crisis and that the reduction of net financial flows took place at the same time that the risk perception of the LAC economies increased. The reduction in remittances was critical for many LAC in particular in Central America. However, since the last quarter of 2009, LAC economies had restored access to international financial markets, but capital inflows remained below pre-crisis levels. An important feature of the recent financial inflows was that high rate of growth of often most volatile portfolio investments, particularly bond issues and syndicated loans. This opened up issues related to exchange rate, financial stability and the use of capital controls. For

2010 and 2011, it was expected that private financial flows to LAC economies would experience a significant increase, in particular the FDI component.

The presenter highlighted that unlike in past crises, international financial institutions assisted several LAC countries rather expeditiously during the current crisis. The IMF granted financial assistance to several economies in the region with more flexible conditionality. The World Bank also increased loans and introduced more flexible instruments to help countries during the crisis. Regional and sub-regional financial institutions also played a significant role in the region by providing credit at more flexible conditions, particularly in helping finance liquidity needs of small countries. Additional financial assistance to Central Banks in the region was provided by the US Federal Reserve and the People's Bank of China.

He finished his presentation by formulating some questions about international financial institutions. He wondered whether they would be able to reduce the traditional volatility exhibited by private flows, reduce systemic risk by improving supervision of systemic players in the international financial markets and enhance the coordination among the global, regional, sub-regional and national entities responsible of providing financial stability. He also asked whether the IFIs would reduce the volatility of financial resources for development, provide new sources to finance economic and social development and work to improve the international reserve system. He added that given the fiscal positions of developed economies, there was a question whether they would be competing for financing with developing economies.

Mr. Elliot Harris, Special Representative of the IMF to the UN, made a presentation on "the IMF's New Lending Framework", stressing IMF's Crisis Response, Macroeconomic Policy Design and Structural Conditionality.

With respect to the IMF's Crisis Response, Mr. Harris explained that there had been a comprehensive overhaul of non-concessional lending facilities. (1) The Flexible Credit Line (FCL) was introduced for countries with very strong fundamentals, policies, and track records of policy implementation, particularly useful for crisis prevention purposes. It would be approved for countries meeting pre-set qualification criteria and determined on a case-by-case basis; (2) Enhanced flexibility of the Stand-By arrangement (SBA) would enable high-access on a precautionary basis and provide increased flexibility by allowing frontloading of access and reducing the frequency of reviews and purchases where warranted by the strength of the country's policies and the nature of the balance of payments problem faced by the country. (3) Simplification of facilities was done through elimination of certain little used facilities (Supplemental Reserve Facility and Short-Term Liquidity facilities). (4) Doubling annual access limits (to 200 per cent of quota) and cumulative access limits (to 600 per cent of quota) aimed to give confidence to countries that adequate resources would be accessible to them to meet their financing needs. (5) Adapting and simplifying cost structures of high-access and precautionary lending would effectively lengthen grace periods and simplify the repayment schedules of Fund lending. A modernized and streamlined conditionality framework focused on and adequately tailored to the varying strengths of country policies and fundamentals.

Another change to crisis response was the establishment of a comprehensive LIC support package tailored to individual circumstances of each country. This would be attained through a simplified structure: (1) An Extended Credit Facility (ECF) to provide flexible medium-term support (2-3 years); (2) Rapid Credit Facility, offering emergency support with limited conditionality (urgent needs); and a (3**)** Standby Credit Facility to address short-term and precautionary needs (episodic support). In addition to structure changes, there were changes to global access limits and norms and more concessional support for LICs.

With respect to Macroeconomic Policy Design, Mr. Harris noted that there was an emphasis on social spending and on poverty reduction and better targeting of vulnerable groups. There was increased flexibility and policy space through changes in programme design and assembly, incorporation of expectation of economic downturn and accommodation of higher inflation, current account deficits and countercyclical fiscal policy.

A new Structural Conditionality Framework had been put in place whereby the IMF would rely more on pre-set qualification criteria (ex-ante conditionality), where appropriate, rather than on traditional (ex- post) conditionality as the basis for providing access to Fund resources. Implementation of structural policies in IMF-supported programmes would from now on be monitored in the context of programme reviews. The use of structural performance criteria would be discontinued in all Fund arrangements, including those with low-income countries. The focus of reviews would be on structural benchmarks instead of time-bound measures to provide countries with more flexibility in order to enhance ownership and the likelihood of improving results.

Finally, regarding exit strategies from fiscal stimulus packages directed at supporting short-term economic activity, the speaker suggested that countries should begin to prepare to realign policies toward medium-term sustainability once the recovery was clearly on the move.

As an update on G-20 commitments, Mr. Harris asserted that the IMF had trebled its resources to $750 billion by September 2009 ($500 billion from G-20 and three non-G-20 members plus $250 billion in own resources). Also, there had been an increase of at least $100 billion more from multilateral development bank lending.

A $250 billion SDR allocation was made in August 2009, of which nearly $100 billion went to developing and emerging countries. Also additional concessional resources from IMF gold sales had been used to fund $0.5-$0.6 billion in subsidies. $250 billion support for trade finance was committed at the London Summit, with an additional 150 billion in contingency funding identified in August, which had an average utilization rate of more than 66 per cent in first half 2009 to about 40 per cent in second half as private markets recovered.

Ms. Lisa Schineller, Director for Sovereign Ratings in Latin America, Standard and Poor's, gave a presentation on the sovereign credit rating methodology of Standard and Poor's in Latin America and the Caribbean. Ms. Schineller focused the initial part of her presentation on the basic concepts of credit rating and risk assessment and difference between sovereign ratings and country risk. She emphasized that Standard & Poor's did not rate countries but sovereign governments and other public and private sector entities which could issue debt. A sovereign rating was a globally comparable, independent, objective, forward-looking opinion on the creditworthiness of a sovereign government. The assessment pertained largely to the timely service of debt and reflected medium-term fundamentals.

She also underscored that sovereign ratings were not country risk ratings or country investment rankings. Furthermore, they did not convey a recommendation to buy, sell or hold a security, or predict the stability or volatility of a security's price. The willingness-to-pay component distinguished sovereigns from many other types of issuers as sovereigns could and sometimes did change their laws and creditors had only limited legal redress. Country risk affected non-sovereign ratings and included a broad range of political, legal, economic and industry factors since it was the aggregate of the specific risks involved in doing business with a particular country. The speaker emphasized that sovereign credit ratings and country risk were highly correlated in that sovereigns with the lowest risk tended to be in countries with the least country risk, as evidenced by stable political systems, well-developed legal frameworks and open, market-oriented economies.

The sovereign rating methodology would take into account credit and political factors. Credit factors included the income and economic structure, fiscal and monetary policies, debt burdens, liquidity and economic growth prospects. Political factors comprised the stability and legitimacy of political institutions, popular participation, the process of succession, transparency and geopolitical factors. However, she underlined the fact that factors could vary and that the final sovereign rating did not necessarily reflect on each factor individually. For example, a sovereign with a low rating might have a fairly flexible labor market or favorable regulatory structures. There was no "sovereign ceiling" to ratings and sometimes entities within a country would be rated higher than the sovereign when they exhibited sound credit characteristics and were sheltered from sovereign risk factors.

Ms. Schineller further highlighted that ratings were issued on request and subject to extensive surveillance, which included analyses of political and economic cycles, annual reviews and reevaluations whenever fundamentals seemed to be changing. The number of national governments that requested ratings had increased drastically since the mid-1980s leading to a much wider range of ratings as opposed to the mostly triple-A rated countries in the 1970s.

Summary of the discussion

The representative of Yemen (on behalf of G77 and China) called for increased global liquidity to overcome the financial crisis. He recalled that the Outcome Document of the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development correctly identified the potential of expanded SDRs as a response to the financial shortfalls and the development needs of the poor and vulnerable countries. Increased SDR allocations were an effective and low cost measure free of conditionalities that would quickly boost global liquidity and provide developing countries in need with the means to meet their external financing gap and to implement counter-cyclical policies to mitigate the impact of the crisis. Therefore, it was important to further examine the role of enhanced SDRs in the expansion of liquidity, stabilization and reform of the global reserve system. The Group also underlined the need to promote the use of SDRs for development purposes and called for a new and significant, general SDR allocation in to meet liquidity needs and promote development, followed by regular SDR allocations. Regional and sub-regional efforts could also have a complementary role in liquidity provision and development.

The speaker emphasized the need for a more efficient international reserve system, which would help avoid the problems resulting from the current over reliance on one dominant national currency. The potential for enhanced SDRs to help mitigate the inequality bias of the current global reserve system should be further studied. In this regard, the Group reiterated its request to the Secretary-General to present a report on the role of expanded SDRs by the end of the sixty fifth session of the General Assembly. Moreover, the global reserve system could be further complemented by strengthened regional commercial and reserve arrangements.

The representative recalled that the Outcome Document also highlighted fiscal space and the need to close the financing gap, flexibility to implement countercyclical policies, the need to streamline conditionalities and the right to use capital restrictions. In this connection, the BWIs should not impose pro-cyclical policies and conditionalties that limited policy space to promote development. Moreover, multilateral development banks should move forward on flexible, concessional and conditionality free, fast disbursing and frontloaded instruments. The recent financial crisis illustrated that more accommodating macroeconomic policies, more inclusive and pro-poor policies, as well as greater government involvement were possibly more effective in protecting countries from the effects of a financial crisis than orthodox economic measures.

The representative of Chile (on behalf of the Rio Group) emphasized the need for cooperation and international coordination to mitigate the effects of the financial crisis and promote measures toward sustained economic growth, eradication of poverty and sustainable development. More resources, both in terms of short-term liquidity and long-term financing for development, were needed to finance balance of payments and increase fiscal space in developing countries. There was a need to improve international financial institution lending facilities and practices, with the establishment of simpler credit facilities that disbursed funds more rapidly, were free of conditionalities and followed transparent and equitable criteria. Decisive progress in this regard was closely linked to an increase in voice and participation of developing countries in these bodies. The Group further emphasized the importance of new general and regular SDR allocations for increased international liquidity and development finance.

The representative of Belgium (on behalf of the European Union) stressed that the risk of protectionism persisted as unemployment remained high in many countries. To avoid protectionism, continued monitoring and peer pressure among trading partners were still needed. He noted that with recovery in the global economy, credible exit strategies should be designed and communicated clearly to anchor expectations and reinforce confidence, to ensure a sustained economic recovery. International coordination in changing macroeconomic stance should be based on guiding principles of appropriate timing and ambitious size and pace, related policies such as strengthening national budgetary frameworks, structural economic reforms and proper sequencing of exit measures, beginning with withdrawal of fiscal stimulus and business support.

On additional resources for developing countries, the speaker highlighted the need for renewed international efforts, including by emerging market economies, to secure additional resources for concessional lending by IMF. At the same time the multilateral development banks (MDBs) needed a sustainable income model to be able to fulfill their development financing mandate. He welcomed recent capital increases at a number of the regional development banks but cautioned that capital increase in the non-concessional arms should not be at the expense of the concessional arms. He affirmed the EU’s commitment to working with others to make the new crisis response window of the World Bank a success. The speaker reaffirmed the EUs commitment to spending 0.7 per cent of GNI on ODA and invited other donors and new development partners to step up their efforts and contribute their fair share. He added that the international community should ensure that domestic resources of developing countries were fully mobilized and at the same time, develop new and stable sources of financing to meet global challenges.

Noting good progress on a number of important G20 commitments to support developing countries, the representative saw scope for follow-up on others, notably replenishment of IDA 16 and the IMF Poverty Reduction and Growth Trust, conclusion of the Doha Round, access to energy, food security, illicit capital outflows climate change finance and continuation of voting reform in the World Bank.

The speaker believed that IMF's new lending facilities were an important step in modernizing and streamlining conditionality and the experience with the new conditionality framework needed to be assessed. He stressed that the ex-ante conditionality for the Flexible Credit Line (FCL) was a major innovation that should only apply to the best performers.

The representative stated that the global financial and economic crisis had demonstrated the importance of compliance with international rules. An important lesson learned was that rules in the financial sector, in particular, needed to be strengthened and it should not be left up to each country to select the rules that they would want to apply.

The speaker went on to note that the recent IMF allocation of $283 billion worth of SDRs, $100 billion of which for supplementing developing country reserves, was an important in easing global liquidity constraints. He reminded that SDR financing was not "free money" since they had implicit inflation and sterilization costs.

The EU expected that in the medium term, there would be spontaneous and gradual transformation of the global reserve system into a bi-polar international monetary system, in which the dollar and the euro would play an important role. The EU would be open to further analytical work on multilateral reserve currency arrangements. In this connection, the EU could envision that when emerging market economy currencies became fully convertible they could play an international role and potentially help create a multi-currency reserve system.

Finally, the speaker called for assessment of the experience with the revamped lending facilities deployed as global financial safety nets during the financial crisis. He stated EU's support of a review of country experiences and lending instruments to evaluate the needed improvements and their complementarity to self-insurance. This review should include IMF crisis prevention and resolution mechanisms as well as the coherence of bilateral, regional and global financial arrangements.

The representative of the Russian Federation supported efforts to reform the global reserve system and highlighted the need for coordination among reserve currency countries. He suggested stepped-up efforts in expanding the role of regional currencies, acknowledging the need for countries to meet the prerequisites for the use of regional currencies in trade and exchange. He posed a question about the prospects of the broader use of regional currencies.

The representative of <u>Switzerland</u> discussed the key international and national factors that shaped fiscal space, noting that in many developing countries, favourable macroeconomic conditions prior to the crisis, provided them with fiscal space in their response to the crisis. Flexible provision of liquidity by the international financial institutions (IFIs) and by bilateral assistance without excessive conditionality played an important role. The challenge was for countries to maintain long-term fiscal sustainability. In this context, the provision of technical assistance to developing countries to address structural challenges, growth objectives and achievement of the MDGs would be needed.

He also noted that the current global reserve system risked high instability in exchange rate and subsidized the interest rate of the reserve currency country. International policies aimed at stabilization of exchange rate could also impede global growth.

The speaker posed a question about how powerful credit ratings were in affecting investment and financial markets and about the criticism of credit rating agencies' contribution to pro-cyclicality of capital flows.

The representative of <u>Mexico</u> asked about the sustainability of the growth pattern in Latin America, which was primarily linked to commodity prices. He also emphasized the importance of ensuring that developing countries could get the financing needed during financial instability, citing Mexico's use of the FCL He posed a question about the guarantees for methodological soundness of credit ratings and about the major challenges in the rating of debt and investment.

The representative of <u>Venezuela</u> asked panelists to elaborate on the potential of sub-regional financial instruments in providing liquidity. He noted the inequity of the current international financial system and called on the use of SDRs to provide international liquidity which could avoid some of the undesirable consequences of bilateral financing. Regional and sub-regional initiatives on reserve currencies needed study. He proposed a technical committee within the Ad Hoc Working Group to address the process of bolstering the role of SDRs in the necessary overhaul of the global reserve system.

The representative of <u>Indonesia</u> noted that even with the institution of the FCL, many countries were still not keen to use the facility because of the issue of dealing with IMF and the stigma of borrowing from it. He put forward alternative mechanisms of crisis financing: 1) flexible instruments for programmatic financing during financial turmoil e.g. an ad hoc mechanism in Asia that helped to reduce capital flight; 2) plans for IMF's role in bilateral swap arrangements. With regard to ratings, he asked about the difference between country rating and sovereign rating and how they influence each other and the frequency of review of ratings.

The representative of <u>Pakistan</u> asked the panelist from the IMF whether enough had been done in providing financing relative to the impact of the crisis. Also, he wanted to know how far developing countries were involved in designing crisis measures and whether response measures were time-bound. Regarding credit ratings, he asked whether rating agencies themselves were assessed. In addition, as developing countries were large investors in developed country government securities, he wanted to know whether investors were involved in the rating process.

The representative of Antigua and Barbuda asked whether there had been any review in methodology of sovereign credit ratings since the crisis and specifically, about any change in trend in the ratings for the Caribbean countries. She inquired about IMF's views on the implications for debt sustainability of countries using the new IMF lending facilities, including how the review of the debt sustainability framework was applied to small Caribbean countries for the short- and medium-term given the sharp rise in their debt the GDP ratio since the crisis.

The representative of Argentina pointed out that credit ratings reflected the perception of risk in the market and asked about the utility of ratings. He was interested in any discussion of the rapid fall of credit ratings of some sovereigns in the past and what was behind them. He asked about how to address concerns about ratings and the motivation behind the G20's call for supervision of credit rating agencies. He highlighted that explanations provided on how ratings were arrived at would increase the transparency of credit ratings. Regarding SDRs, he asked about the possibility of a new SDR issuance.

The representative of Brazil pointed out that the insufficiency of financing for developing countries in Latin America since the crisis was reflected in the increase in the number of poor in the region. He reiterated the importance of conditionalities and financing in shaping fiscal space in developing countries and underscored that developing countries were facing difficulty in access to financing and higher financing cost post-crisis. The reliance of the global reserve system primarily on one national currency had resulted in greater instability and he suggested that regional currency arrangements could be a useful way to increase stability in the short term.

The speaker emphasized the important role of the UN in providing the best forum for the broad and cross-cutting discussions of all issues pertaining to the international financial system and development, including specialized areas such as financial regulation and supervision. The Ad Hoc Working Group could be useful in putting changes in perspective and therefore continued discussion of all these issues and their implication for development and new thinking was needed. He was open to considering possible committees in the Working Group as suggested by Venezuela.

The speaker was of the view that the process of credit rating was not truly an assessment as it only considered the government's creditworthiness to private creditors but not its responsibility to it own population in terms of social conditions. In addition, the transparency of government finances had deteriorated, as in some European countries, where financial instruments and accounting methods could be used to obfuscate the actual level of financial risk and elude rating agencies.

The representative of Canada reiterated the importance of keeping markets open in order to help the entrenchment of the global economic recovery. He called for using the opportunity provided by reform of conditionalities to have efficient, focused and responsible IFIs. At the same time, IFIs needed to have the necessary resources to respond to financing needs during crisis, especially the MDBs, in order to meet their development financing mandate in emerging and developing economies. He stressed the importance of ensuring that the present recovery benefited everyone. He also noted that the importance of pre-crisis macroeconomic policy stance and access to finance during the crisis presented lessons in crisis prevention and response.

Concluding remarks by the panelists

In response to questions from the floor, Ms. Schineller highlighted that ratings were as powerful as markets wanted them to be. The reputation of the rating agencies was a key element in the determination of their influence. However, ratings were only one factor in the investment decision process. Sovereign ratings could change independently of the market. Frequently, there were divergences between ratings and market sentiment. Ms. Schineller recognized that more transparency was important. The overvaluation of mortgage-backed securities had led to a change of ratings criteria that incorporated public input. Procyclicality between market movements and ratings may occur, yet the idea was not to follow the market trend but to look for a consolidated trend based on informed quantitative and qualitative analysis. Rating agencies were regulated by regulatory agencies in their country (for example, in the US through the Securities and Exchange Commission). She further highlighted that the credit outlook for the Caribbean was somewhat more negative than the rest of Latin America, since these countries suffered particularly heavily from the crisis due to their proximity and links to the US economy.

In response to questions from the delegates, Mr. Harris reminded participants that the market determined which currencies were used as international reserves and that it was not something determined by a particular institution or country.

He explained that country assessments were not done at a desk in Washington, but that they were done in particular countries with their participation and never imposed.

With respect to SDR allocations, he responded that it was the institutional view of the IMF that SDRs were not a tool for development financing but were to be used for liquidity purposes and as a reserve agent.

Mr. Titelman also addressed the issue of using different currencies as reserves and in sub-regional arrangements, saying that a currency would have to have a good record of liquidity, be widely recognized and used for international transactions and have extensive trade utilization. Hence, it would take a long time for a currency to achieve global reserve status. In the case of Latin America, local currencies had been used for transaction purposes between countries, but not as a reserve to store value. He added that the reserve system should not be confused with the international financial system.