

Chapter III

Financial flows to developing countries

Net resource transfers from poor to rich countries

Developing countries as a group are expected to have continued to provide a net transfer of financial resources,¹ of approximately \$557 billion, to developed countries in 2010 (see figures III.1a-b and table III.1). The volume of net financial resource transfers was up slightly from 2009, but remained well below the peak of \$881 billion in 2007. The decline in net transfers since 2007 reflected narrowing global trade imbalances as a result of the dampening effect of the global recession on imports of major deficit countries. As discussed in chapter I, this change was transitory, and net transfers from developing to developed countries increased again during 2010. The aggregate trade surplus of developing countries also increased again as exports recovered, while private portfolio capital inflows surged. This situation allowed for additional reserve accumulation by these countries.

Western Asia and Africa experienced the strongest increase in net outward resource transfers in 2010, reflecting much higher export revenues of net fuel exporters in both regions, owing to the rebound in oil prices. Low-income countries in sub-Saharan Africa are expected to remain recipients, however, and to continue to receive positive net transfers, as are the group of low-income countries as a whole (figure III.1b). The crisis hurt export revenues, while more compensatory financing was made available to them. The net inflow of resource transfers to low-income countries is expected to increase slightly in 2010, but may taper off in the outlook if official development assistance (ODA) suffers from the fiscal retrenchment in many donor countries.

Net transfers from East and South Asia continued to decline modestly in 2010, along with China's smaller trade surplus. Net transfers from Latin America and Caribbean countries similarly declined moderately, influenced by factors that included the return of private capital flows. Net outward transfers from economies in transition increased substantially in 2010 as trade surpluses increased from the rebound in oil export revenues of the Russian Federation and other net fuel exporters of the Commonwealth of Independent States (CIS).

Net resource transfers from developing countries are expected to increase moderately along with the projected widening of current-account imbalances (see chap. I). This continuation of the pre-crisis pattern in which poor countries transfer significant resources to much richer nations also reflects the need felt by developing countries to continue accumulating foreign-exchange reserves as self-protection against new global economic shocks. Instances of global financial market turbulence, enhanced exchange-rate volatility among the major reserve currencies and the short-term surges and volatile private capital flows have added to high macroeconomic uncertainty and the perceived need for self-protection during 2010. Several emerging markets and other developing countries have responded with new capital controls and foreign-exchange rate market interventions in order to mitigate

Net transfers from developing to developed countries increased again in 2010

Western Asia and Africa experienced the greatest increase in outward resource transfers

The trend of increasing resource transfers from developing countries is set to continue

¹ The net transfer of financial resources measures the total receipts of financial and other resource inflows from abroad and foreign investment income minus total resource outflows, including increases in foreign reserves and foreign investment income payments. The net transfer of a country's financial resources is thus defined as the financial counterpart to the balance of trade in goods and services.

Figure III.1a
Net financial transfers to economies in transition
and developing countries, 1998-2010

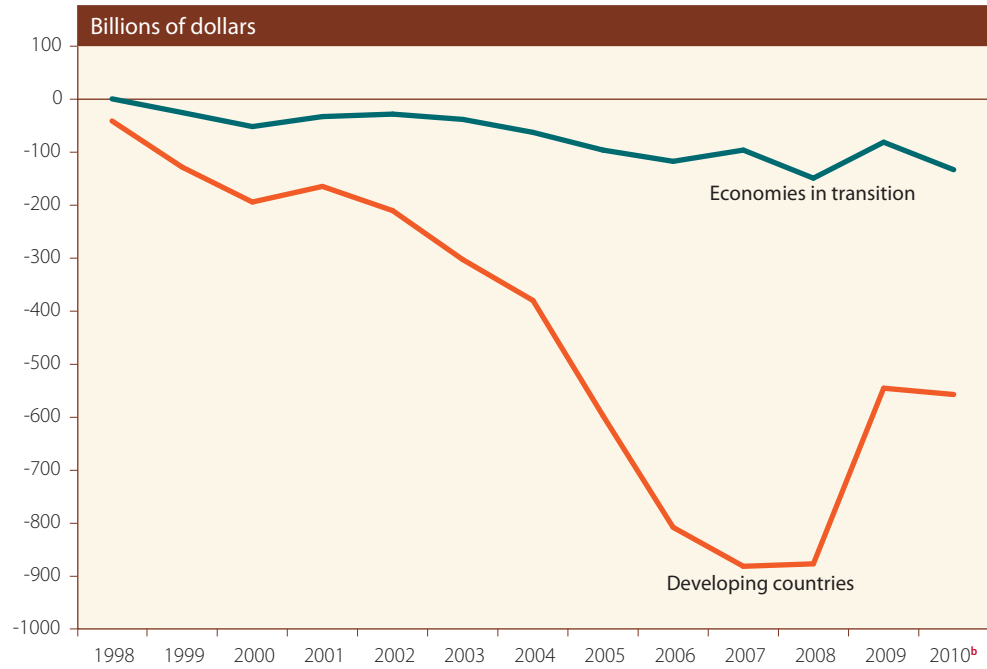
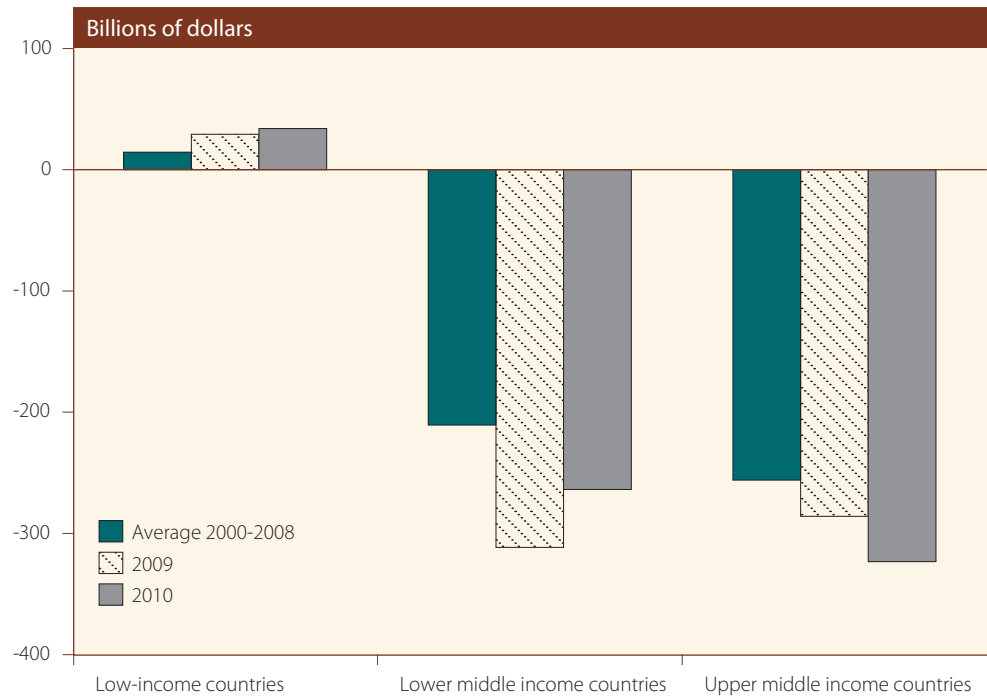


Figure III.1b
Net financial transfers, by income categories, 2000-2010



Source: UN/DESA, based on IMF, World Economic Outlook Database, October 2010; and IMF, Balance of Payments Statistics.

Table III.1

Net transfer of financial resources to developing economies and economies in transition, 1998-2010

Billions of dollars													
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 ^a
Developing economies	-41.0	-128.0	-194.0	-164.4	-210.2	-302.7	-379.5	-597.2	-807.8	-881.1	-876.4	-545.1	-557.0
Africa	2.9	1.6	-31.7	-16.4	-4.2	-16.1	-34.5	-76.4	-108.3	-100.9	-99.1	2.9	-35.3
Sub-Saharan Africa (excluding Nigeria and South Africa)	11.5	7.9	2.3	6.4	4.4	5.3	3.5	-0.6	-10.5	-9.1	-4.8	27.3	14.6
East and South Asia	-129.8	-139.8	-122.8	-120.8	-149.2	-175.6	-183.4	-265.7	-385.7	-529.8	-481.3	-427.5	-352.9
Western Asia	34.5	2.7	-35.3	-29.7	-23.2	-46.7	-76.3	-143.7	-175.6	-144.0	-222.5	-48.4	-112.7
Latin America and the Caribbean	41.5	7.4	-4.2	2.5	-33.6	-64.3	-85.4	-111.4	-138.0	-106.4	-73.5	-72.1	-56.1
Economies in transition	0.7	-25.1	-51.6	-32.9	-28.0	-38.0	-62.5	-96.0	-117.1	-95.9	-149.1	-81.1	-133.0
Memorandum items:													
Heavily indebted poor countries (HIPC)s	8.8	9.5	7.9	8.3	8.9	8.8	10.7	13.4	11.2	19.0	31.0	29.6	31.0
Least developed countries ^b	12.5	10.2	5.0	8.2	5.9	7.5	5.0	1.3	-7.9	-5.2	-4.5	26.3	16.8

Source: UN/DESA, based on IMF, *World Economic Outlook Database*, October 2010; and IMF, Balance of Payments Statistics.

^a Partly estimated.

^b Cape Verde graduated in December 2007 and is not included in the calculations.

the adverse impacts of these developments on their economies. In spite of the increased availability of international assistance, developing economies will continue to accumulate reserves for self-protection as a first line of defence against financial shock. Despite the effective use of foreign reserve holdings by emerging market economies to buffer the impact of financial instability, capital outflows from these countries during the financial crisis have highlighted the importance of building a global financial safety net. During 2010, there has been some progress in tightening international rules for regulating financial sectors worldwide to enhance the voice and representation of developing countries in the Bretton Woods institutions. But key systemic issues, such as the faltering global reserve system, an inadequate global financial safety net, the lack of sovereign debt workout mechanisms and deficiencies in the existing global economic governance mechanisms still need to be tackled to safeguard against further, potentially severe, global instability in the future.

Private capital flows to developing countries

Net private capital flows to developing countries have continued to recover strongly from their slump in 2008 and early 2009.² They increased from about \$110 billion in 2008 to about \$386 billion in 2009 and are estimated to have grown strongly in 2010 (see table III.2). This trend has been driven by the combination of stronger economic growth in a number of developing countries and problematic economic fundamentals in many advanced economies. Extensive monetary easing has kept interest rates low, while fragility in the financial

Net private capital flows to developing countries have increased significantly

² Unlike the section on international finance in chapter I, net capital flows are defined here as "net net", that is to say, net capital inflows less net capital outflows; coverage is of all developing countries and economies in transition. At variance with the net transfer concept, net capital outflows refer only to items of the capital account (including reserves) of the balance of payments.

Table III.2
Net financial flows^a to developing countries and economies in transition, 1997-2011

	Average annual flow		2007	2008	2009	2010 ^b	2011 ^c
	1997-2000	2001-2006					
Developing countries							
Net private capital flows	92.3	103.5	383.7	110.0	385.7	659.2	602.8
Net direct investment	146.4	161.9	311.8	341.6	193.3	247.5	270.9
Net portfolio investment ^d	31.1	-59.4	7.7	-135.5	77.7	93.4	79.9
Other net investment ^e	-85.3	1.0	64.1	-96.0	114.7	318.2	252.1
Net official flows	-0.4	-69.1	-140.7	-113.5	-26.8	-249.4	-217.7
Total net flows	91.9	34.4	243.0	-3.5	358.9	409.7	385.1
Change in reserves ^f	-76.7	-373.1	-1059.4	-787.8	-687.5	-654.2	-561.6
Africa							
Net private capital flows	7.8	13.3	31.5	26.0	38.8	53.8	57.4
Net direct investment	8.5	22.5	41.9	52.5	42.3	39.9	50.3
Net portfolio investment ^d	2.3	3.7	8.4	-31.1	-3.4	14.4	12.9
Other net investment ^e	-3.0	-12.8	-18.8	4.6	-0.1	-0.5	-5.7
Net official flows	0.9	-10.3	-6.7	-1.2	8.9	12.9	15.4
Total net flows	8.7	3.0	24.8	24.9	47.7	66.7	72.8
Change in reserves ^f	-8.0	-34.8	-86.9	-75.3	1.5	-25.3	-26.6
East and South Asia							
Net private capital flows	4.7	65.7	137.6	-23.6	267.2	426.4	377.7
Net direct investment	62.8	72.8	133.6	138.9	57.3	67.8	63.7
Net portfolio investment ^d	20.9	-34.9	2.2	-88.8	27.9	48.0	40.0
Other net investment ^e	-79.0	27.8	1.8	-73.7	182.0	310.6	273.9
Net official flows	-0.4	-16.3	-43.4	-17.5	-16.5	-259.9	-185.2
Total net flows	4.2	49.5	94.2	-41.1	250.7	166.5	192.5
Change in reserves ^f	-59.7	-269.2	-674.5	-529.0	-644.1	-497.1	-460.7
Western Asia							
Net private capital flows	15.9	-2.7	109.1	50.1	56.0	47.3	34.5
Net direct investment	6.6	18.2	49.5	57.8	31.2	61.8	60.8
Net portfolio investment ^d	-4.8	-20.7	-39.2	2.2	22.1	-17.0	-13.0
Other net investment ^e	14.1	-0.3	98.9	-9.8	2.7	2.5	-13.3
Net official flows	-7.7	-32.7	-84.8	-96.1	-64.1	-28.9	-54.3
Total net flows	8.2	-35.4	24.3	-46.0	-8.1	18.5	-19.9
Change in reserves ^f	-6.6	-46.4	-164.8	-133.2	6.4	-56.8	-45.8
Latin America and the Caribbean							
Net private capital flows	63.9	27.2	105.4	57.4	23.7	131.6	133.2
Net direct investment	68.5	48.4	86.8	92.4	62.6	78.1	96.0
Net portfolio investment ^d	12.7	-7.5	36.4	-17.9	31.1	48.0	40.0
Other net investment ^e	-17.3	-13.7	-17.8	-17.1	-69.9	5.6	-2.8
Net official flows	6.8	-9.7	-5.7	1.3	44.9	26.4	6.4
Total net flows	70.8	17.5	99.6	58.7	68.6	158.1	139.6
Change in reserves ^f	-2.4	-22.6	-133.2	-50.2	-51.2	-75.0	-28.5

Table III.2 (cont'd)

	Average annual flow		2007	2008	2009	2010 ^b	2011 ^c
	1997-2000	2001-2006					
Economies in transition							
Net private capital flows	-20.1	27.7	149.0	-77.2	-49.6	1.9	14.2
Net direct investment	5.8	14.3	39.3	62.0	21.6	25.6	36.2
Net portfolio investment ^d	-12.7	2.9	20.9	-32.3	-10.4	-0.5	0.5
Other net investment ^e	-13.2	10.5	88.8	-107.0	-60.7	-23.2	-22.5
Net official flows	9.3	-8.9	-5.5	-18.3	46.1	7.5	8.4
Total net flows	-10.7	18.9	143.5	-95.5	-3.5	9.4	22.6
Change in reserves ^f	-4.8	-56.9	-170.3	30.0	-12.1	-69.7	-71.2

Sources: IMF, *World Economic Outlook Database*, October 2010; Institute of International Finance, "Capital flows to emerging market economies", IIF Research Note, 4 October 2010; UNCTAD; and UN/DESA.

a Net financial flows are defined here as "net net", that is to say, net financial inflows less net financial outflows.

b Partly estimated.

c Forecasts.

d Including portfolio debt and equity investment.

e Including short- and long-term bank lending, and possibly including some official flows owing to data limitations.

f Negative values denote increases in reserves.

systems of the major developed economies and the weak recovery continue to constrain credit growth in the major high-income countries. This has created substantial excess liquidity in advanced financial markets. In search of higher returns, investors have shifted to emerging markets. Improving terms of trade have attracted foreign direct investment (FDI) in commodity-exporting economies, contributing to greater private capital flows.

The more favourable perceptions of emerging market risk are also reflected in the narrowing spreads of United States government debt. J.P. Morgan's Emerging Markets Bond Index Plus (EMBI+) spread is, at the time of writing, trading at close to 260 basis points, in comparison to close to 700 basis points at the end of 2008.³

Evidence of an ongoing reallocation of assets by institutional investors towards emerging markets, away from mature economies, is consistent with these developments. Looking ahead, this may continue, driven by both short-term cyclical factors as well as more embedded structural developments. In the immediate period, a further round of monetary easing, led by the United States of America and Japan, would make more funds available to investors that could be used to purchase emerging market assets. On a longer term basis, there is still potential for further significant asset reallocation. The major global financial institutions currently hold between 2 and 7 per cent of their total assets in emerging markets, whereas the share of emerging markets in global gross domestic product (GDP) has increased to more than 30 per cent.⁴ Medium-term projections for strong growth in net private capital flows to developing countries arising from continuing asset reallocation by institutional investors might, however, be tempered by the possibility that a large increase in the public sector financing requirements of developed economies would enhance competition for global funds and raise borrowing costs for developing countries. This could limit the growth in debt flows to developing countries in the near future. As discussed in chapter I, however, global financial market trends are subject to great uncertainty.

Institutional investors have been reallocating assets towards emerging markets

³ J.P. Morgan Emerging Markets Bond Index Plus (EMBI+) database.

⁴ Stefan Wagstyl and David Oakley, "Bubble fears as emerging nations test fresh highs", *Financial Times*, 8 October 2010.

Asia and Latin America, in particular, saw a surge in portfolio inflows

After declining markedly during the crisis, portfolio equity flows to developing countries recovered strongly in 2009 and 2010. This recovery was particularly strong for those countries in Asia and Latin America that are viewed as having better growth prospects. Stockmarkets in Colombia, Indonesia and the Philippines hit record levels in October 2010; markets in Brazil and India also boomed.⁵ The revival in flows from 2009 onwards also reflected a return of investors who had feared that the global crisis would have more severe effects on the corporate sector in emerging economies.⁶

Portfolio debt flows have also been staging a strong recovery from the financial crisis. This has been helped by the fact that both non-bank credit institutions and emerging market issuers of debt have been less damaged by the crisis. In addition, low interest rates in some of the major advanced economies appear to have been encouraging a wave of foreign currency bond issuance in their capital markets by emerging market borrowers. Bond inflows to Latin America and Asia have been particularly strong, as has issuance by the non-financial corporate sector. Non-portfolio debt flows (bank credit) have also rebounded. However, mounting non-performing loans have restrained lending in the transition economies of Europe and Central Asia.

FDI remains the single largest component of private capital flows to developing economies. FDI was affected by the crisis through reduced access to finance for investing firms and low investor confidence as a result of gloomy economic prospects and market conditions. Despite a revival in corporate earnings, the weak global investment environment has limited the recovery in FDI flows.

Outward FDI by companies based in developing countries has also increased. Companies have invested in both developed and developing countries. The rise of South-South FDI is often closely linked to extractive industries and infrastructure.

While the recovery in private capital flows to developing economies can be seen as beneficial, there is concern that a recovery in investor appetite for emerging-market risk could herald a surge in short-term capital flows to certain countries that may generate inflationary pressures and have the potential to destabilize currencies and financial markets. In addition, there are downward risks to the general expectation of continued robustness in private capital flows to the developing world. Most importantly, another round of economic slowdown in developed countries could sharply affect the access to capital of developing economies. Moreover, continuing public debt concerns in Europe could place at risk countries, especially in emerging Europe, whose financial sectors are closely linked to those of highly indebted countries.

The surge in short-term capital flows involves risks to stability in developing countries

International financial cooperation

Official development assistance

The crisis has increased the need for ODA but complicated the delivery on commitments

The global financial crisis and economic recession of 2008 and 2009 negatively impacted many developing countries and has placed severe strain on many low-income countries, making ODA delivery even more critical. The fragile recovery in developed countries and the possible double-dip recession create considerable uncertainty about the future volume of ODA flows. Aid delivery, although higher than 2002 levels, has fallen short of commitments by the donor community.

⁵ Ibid.

⁶ Institute of International Finance, "Capital flows to emerging market economies", IIF Research Note, 4 October 2010.

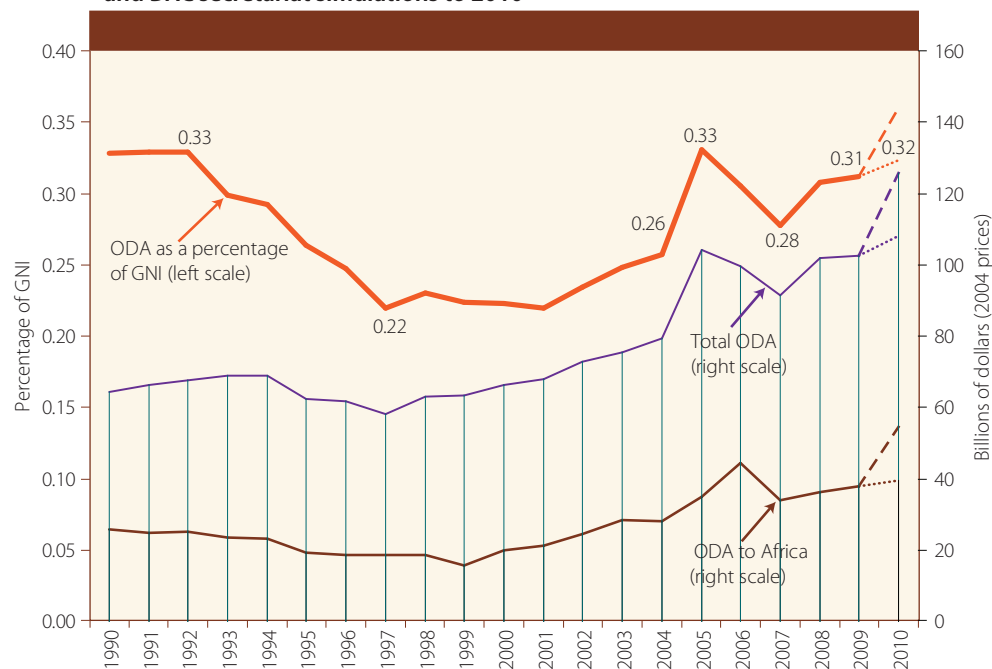
In 2009, total net ODA from the members of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), including the Republic of Korea, whose membership became effective on 1 January 2010, rose slightly by 0.7 per cent in real terms, to \$120 billion. This represented 0.31 per cent of their combined gross national income (GNI). Debt relief—exceptionally high in 2005 and 2006 owing to extraordinary Paris Club packages for Iraq and Nigeria—fell sharply. With the exclusion of debt relief, the rise in ODA in real terms in 2009 was 6.8 per cent. The further exclusion of humanitarian aid brings the increase to 8.5 per cent in real terms. Most of the rise took the form of new lending, but grants also increased.

The pledges made at the 2005 Group of 20 (G20) Gleneagles Summit implied lifting ODA from its 2004 level of about \$80 billion to nearly \$130 billion (at 2004 prices and exchange rates) by 2010, or to 0.36 per cent of the combined GNI of the DAC members. It is now clear that the DAC members as a group will fail to meet the Gleneagles target.⁷ With only modest growth projected, the shortfall in aid delivery will be \$18 billion (in 2004 prices), or \$20 billion (in 2009 prices), against the Gleneagles commitment set for 2010. This shortfall is expected to reduce the volume of ODA to Africa, and the increase in net ODA to that continent in 2010 is now projected to be less than half of the pledged increase of \$25 billion. At 2009 exchange rates and prices, the gap in the delivery against the Gleneagles commitments is \$18 billion, and the delivery gap on commitments for the least developed countries (LDCs) is estimated at between \$23 billion and \$43 billion (table III.3).

The Gleneagles target can be seen as an intermediate commitment towards meeting the longstanding United Nations ODA target of 0.7 per cent of donor GNI. The

The Gleneagles targets will not be reached

Figure III.2
Net ODA of DAC members, 1990–2009,
and DAC secretariat simulations to 2010



Source: OECD/DAC.

Note: Dashed line (----) indicates the growth-adjusted trajectory envisaged at Gleneagles.

Dotted line (....) indicates estimates based on reported intentions or current 2010 budget plans made by DAC members.

Dotted line for Africa (....) indicates a DAC secretariat estimate of probable spending.

⁷ United Nations, *MDG Gap Task Force Report 2010: The Global Partnership for Development at a Critical Juncture* (United Nations publication, Sales No. E.10.I.12).

Table III.3
Official development assistance in 2009 and 2010 in relation to commitments and targets

	<i>Billions of 2004 dollars</i>	<i>Billions of 2009 dollars</i>	<i>Percentage of GNI</i>
Total ODA			
Commitment for 2010	125.8	145.7	..
Delivery in 2009	103.3	119.6	..
Gap in 2009	22.5	26.1	..
Projected shortfall in 2010 ^a	17.7	19.7	..
Overall United Nations target	..	272.2	0.7
Delivery in 2009	..	119.6	0.31
Gap in 2009	..	152.7	0.39
ODA to Africa			
Commitment for 2010	53.1	61.5	..
Delivery in 2009 ^b	37.9	43.9	..
Gap in 2009 ^b	15.2	17.6	..
Projected shortfall in 2010 ^b	14.1	16.3	..
ODA to least developed countries			
Target	..	58.9-78.5	0.15-0.20
Delivery in 2008	..	36.0	0.09
Gap in 2008	..	22.9-42.5	0.06-0.11

Source: United Nations, *MDG Gap Task Force Report 2010: The Global Partnership for Development at a Critical Juncture* (United Nations publication, Sales No. E.10.I.12).

a Based on the OECD review of donors' budget plans for 2010, excluding the Republic of Korea.

b Based on OECD estimates of ODA to Africa.

*MDG Gap Task Force Report 2010*⁸ estimates the gap in delivery towards this commitment at \$153 billion in 2009 (see table III.3). Thus, in order to reach the 2015 target, ODA for 2011-2015 needs to increase by approximately \$35 billion per year.

The United Nations Millennium Development Goals (MDG) summit in September 2010 reiterated the importance of fulfilling all ODA commitments, including that of meeting the target of 0.7 per cent of donor country GNI. All donor countries were strongly encouraged "to establish...rolling indicative timetables that illustrate how they aim to reach their goals, in accordance with their respective budget allocation process".⁹

Only slow progress has been made on improving aid effectiveness as defined by the five principles of the 2005 Paris Declaration—national ownership, alignment, harmonization, managing for results and mutual accountability—with considerable variations across indicators and countries.¹⁰ Slow progress towards the targets is especially visible in countries receiving lower levels of aid, fragile States and LDCs, where distortions in aid allocation have been exacerbated. In 2008, the Accra Agenda for Action reiterated the need for strengthening country ownership, building more effective partnerships, and delivering and accounting for development results. During 2010, further agreements have been reached to improve the quality of aid to fragile States (the Dili Declaration: A new vision for peacebuilding and statebuilding of April 2010) and the quality of development assistance

Little progress has been made in improving aid effectiveness

⁸ Ibid.

⁹ United Nations, General Assembly resolution A/65/1 of 22 September 2010, paragraph 78 (f).

¹⁰ Organization for Economic Cooperation and Development (OECD), *2008 Survey on Monitoring the Paris Declaration: Making Aid More Effective by 2010* (Paris: OECD, 2008).

by middle-income countries, civil society and non-government organizations (NGOs) (the Bogota Statement: Towards Effective and Inclusive Development Partnerships of March 2010). In addition, at the Group of Eight (G8) summit in Muskoka, Canada, on 26 June 2010 leaders endorsed an action plan to enhance efforts towards development-related commitments that included a reconfirmation of commitments to untie aid and disburse it in a timely and predictable manner.

Aid predictability is one of the goals of the Paris Declaration and requires the inclusion of aid commitments in national budgetary plans of donor countries. The 2010 Development Cooperation Forum (DCF) of the United Nations Economic and Social Council recognized that aid predictability had improved in some programme countries, but emphasized that greater flexibility was needed to fund changing priorities and counter exogenous shocks. Durability, stability and flexibility in aid delivery need to be improved further to meet the goal of aid effectiveness. The conditionality attached to aid flows, despite some streamlining, continues to contradict international agreements on national ownership and leadership in policymaking. Donor earmarking of aid also becomes a problem when a donor's priorities do not match the needs and goals of the recipient country and undermine the recipient's leadership in and ownership of budgeting and programming. Progress on mutual accountability, a cornerstone of the Paris Declaration, remains limited. As at end-2009, only seven recipient countries had established fully functioning mutual accountability mechanisms, and the change in donor behaviour was uneven.¹¹

Greater durability, stability and flexibility of ODA are the key elements of improved aid effectiveness

South-South cooperation

South-South cooperation is gaining importance, even though, according to available estimates, it accounts for only 10 per cent of global aid flows. More than 90 per cent of South-South cooperation is "country programmed". Three quarters of South-South aid flows still take the form of project finance, but budget support and debt relief have recently increased in importance. Furthermore, South-South philanthropy is increasing, mainly in social and rural development, as through microfinance charities. Technical cooperation remains vital for smaller providers, and humanitarian assistance is rising rapidly.

South-South cooperation is becoming increasingly important

The 2010 DCF stressed that several features of South-South cooperation set it apart from North-South cooperation. These include the typical absence of policy conditionality, the establishment of horizontal relationships, and the often high degree of complementarity between the cooperating parties. These features are among the reasons the DCF recommended that South-South cooperation need not be subject to the principles of harmonization established by OECD donors.

Innovative sources of development finance

The MDG summit of September 2010 stressed the important role innovative financing mechanisms can play in fulfilling the financing needs of developing countries to accelerate progress towards the international development goals.¹² According to available estimates, innovative sources of finance for development have generated an estimated \$57.1 billion between 2000 and 2008. The most successful of such schemes have supported the implementation of global health programmes.

Greater importance is being attached to innovative financing mechanisms

¹¹ United Nations, *MDG Gap*, op. cit., p. 21.

¹² United Nations, General Assembly resolution A/65/1, op. cit., para. 78 (h).

A financial transactions tax is under consideration

Given the global economic and financial crisis and the need for sources of finance complementary to ODA, greater attention has been given to the possible introduction of an (international) currency or financial transactions tax (CTT or FTT). The G20 Pittsburgh Summit (24 and 25 September 2009) requested the International Monetary Fund (IMF) to evaluate the option of a tax on financial sector activity.¹³ In July 2010, the Leading Group on Innovative Financing for Development released a report on the FTT entitled *Globalizing Solidarity: the Case for Financial Levies*. Based on four criteria (sufficiency; market impact; feasibility; and sustainability and suitability), the report concluded that, among five FTT options,¹⁴ a centrally collected multicurrency transaction tax was the most appropriate for financing global public goods and sharing wealth generated through global financial integration. This option was labelled the “Global Solidarity Levy”. The Leading Group estimated that such a levy could generate as much as between \$25 billion and \$34 billion annually if a tax rate of 0.005 per cent were imposed on global cross-border currency transactions.

During the MDG summit in September 2010, the leaders of France and Spain stressed the need for innovative financing with explicit reference to introducing a global FTT, while 60 member States of the Leading Group, led by Belgium, France and Japan, encouraged non-Leading Group countries to join the initiative to move forward by hosting a high-level side event.

Innovative financing has been successful in supporting global health initiatives

The achievements made so far in the health sector by UNITAID and two multilateral donors utilizing some innovative financing mechanisms—namely, the Global Alliance for Vaccines and Immunisation (GAVI), now called the “GAVI Alliance”, and the Global Fund to Fight AIDS, Tuberculosis and Malaria—have been commended in international forums. Since 2006, UNITAID, an international drug purchasing facility, has raised more than \$1.5 billion for scaling up access to treatments for AIDS, tuberculosis and malaria in 93 countries through multilateral organizations, including the World Health Organization (WHO) and the United Nations Children’s Fund (UNICEF). About 70 per cent of revenues for UNITAID come from air ticket levies introduced in France and one dozen developing countries. A part of Norway’s tax on carbon dioxide (CO₂) emissions from air travel has also been contributed to UNITAID. The remaining part of UNITAID funding comes from multiyear contributions from private foundations and five Governments (including Brazil), of which one country (Spain) collects contributions from air passengers on a voluntary basis.¹⁵ UNITAID now finances antiretroviral drugs for three quarters of the children around the world and has managed to reduce the price of the medicine by more than half.

In March 2010, the Millennium Foundation launched a voluntary solidarity contribution scheme on travel products under the trademark “MASSIVEGOOD” in support of UNITAID funding. The Millennium Foundation estimates that this scheme will generate over \$2 billion annually if implemented globally.¹⁶ In July 2010, UNITAID

¹³ In response, the International Monetary Fund (IMF) published a report entitled “A fair and substantial contribution by the financial sector: Final report for the G20” in June 2010.

¹⁴ The five options examined were: (1) a financial sector activity tax; (2) a value added tax on financial services; (3) a broad FTT; (4) a nationally collected single-currency transaction tax; and (5) a centrally collected global multicurrency transaction tax.

¹⁵ Based on information provided by the delegation of the European Union to the United Nations in its statement delivered during the United Nations Informal Event on Innovative Sources of Development Finance, Panel discussion 1 on “Mechanisms of innovative development financing in operation”, held in New York on 3 June 2010.

¹⁶ Bernard Salome and Philippe Douste-Blazy, “The voluntary solidarity contribution project for UNITAID”, in *Innovative Financing for Development: The I-8 Group Leading Innovative Financing for Equity* [L.I.F.E.], Philippe Douste-Balzy, ed. (New York: United Nations, December 2009).

established a voluntary patent pool mechanism, the Medicines Patent Pool Foundation, under which the production of new HIV/AIDS medicines will be facilitated to make them available in developing countries at more affordable prices. In September 2010, the United States National Institutes of Health became the first patent holder to share its intellectual property with the Medicines Patent Pool.¹⁷

The GAVI Alliance and the Global Fund have become the major multilateral donors in the health sector, having contributed to the 14 per cent growth in global health funding from 2000 (\$5.5 billion) to 2007 (\$13.5 billion).¹⁸ In 2008, the Global Fund was the second-largest multilateral donor in the health sector with a commitment of \$2.2 billion, or 12 per cent of total donor commitments, and the GAVI Alliance was ranked the fifth-largest donor. From 2000 to July of 2010, the GAVI Alliance had received total donor commitments of \$10.6 billion.¹⁹ From 2001 to September of 2010, the Global Fund had received \$18.2 billion against pledges of \$30.1 billion.²⁰ These funds make use of different mechanisms of innovative financing, but further expansion remains challenging (see box III.1). As a result, the scale of revenues generated through currently operational mechanisms for global health initiatives is too small to meet funding needs. At the Global Fund's Third Voluntary Replenishment meeting, more than 40 countries committed \$11.7 billion for 2011-2013, up from the \$9.7 billion provided during 2008-2010.²¹ The new commitment falls short of the lower bound of the estimated funding needs of \$13 billion. No firm pledges were obtained from the private sector, nor could they be secured through innovative funding mechanisms. UNITAID also faces a funding challenge. As at June 2010, there was a delay in receiving committed funds from some donors, and only four donors had committed funding for 2011.²²

Additional funding would need to be secured in order to scale up operations and step up efforts to meet the internationally agreed health goals. Recognizing these needs, the G8 reaffirmed its commitment to improving the health of mothers and young children in the developing world in its 27 June 2010 Muskoka Initiative on Maternal, Newborn and Child Health,²³ while the United Nations Global Strategy for Women's and Children's Health was launched at the MDG summit.

The GAVI Alliance and the Global Fund face funding challenges

¹⁷ UNITAID, "US National Institutes of Health (NIH) First to Share Patents with Medicines Patent Pool", 30 September 2010, available from <http://www.unitaid.eu/en/20100930290/News/US-National-Institutes-of-Health-NIH-First-to-Share-Patents-with-Medicines-Patent-Pool.html>.

¹⁸ OECD, *2010 DAC Report on Multilateral Aid* (Paris: OECD, September 2010).

¹⁹ GAVI Alliance, "Donor contributions & commitments: latest figures as of October 2010", available from <http://www.gavialliance.org/about/donors/table/index.php> (accessed on 23 November 2010).

²⁰ Global Fund to Fight AIDS, Tuberculosis and Malaria, "Pledges as of 31 October 2010", available from http://www.theglobalfund.org/documents/pledges_contributions.xls (accessed on 23 November 2010).

²¹ Global Fund to Fight AIDS, Tuberculosis and Malaria, "Donors commit US\$ 11.7 billion to the Global Fund for next three years", press release, 5 October 2010, available from http://www.theglobalfund.org/en/pressreleases/?pr=pr_101005c. According to a list of pledges for 2011-2013, the Global Fund expects about 2 per cent of revenues during this period (\$109 million) to be generated from the Debt2Health initiative and other innovative financing schemes (\$163 million). The role played by the innovative mechanisms in the overall funding remains modest.

²² UNITAID, "More countries should apply solidarity air levy to complement funding for global health: Secure funding key to keep expanding treatment for people with AIDS, Malaria and TB", press release of 10 June 2010, available from <http://www.unitaid.eu/en/20100610264/News/MORE-COUNTRIES-SHOULD-APPLY-SOLIDARITY-AIR-LEVY-TO-COMPLEMENT-FUNDING-FOR-GLOBAL-HEALTH.html>.

²³ G8 Muskoka Declaration: Recovery and New Beginnings, Muskoka, Canada, 25-26 June 2010, available from http://g8.gc.ca/wp-content/uploads/2010/07/declaration_eng.pdf.

Box III.1

Mechanisms underlying innovative financing for global health

Innovative forms of financing have been effectively introduced to support global health initiatives. The two innovative mechanisms used by the GAVI Alliance are the International Financing Facility for Immunisation (IFFIm) and the Advance Market Commitment (AMC). The IFFIm has been the major source of funding for GAVI since 2006, having raised \$2.6 billion (as of March 2010), mostly through issuance of foreign currency-denominated bonds against long-term official development assistance (ODA) pledges of \$6 billion made by nine donor countries (including South Africa). In relation to the overall financial requirements of \$4.3 billion for 2010-2015, GAVI expects that these two mechanisms will generate revenues to cover about half of its funding needs, namely, \$1.3 billion through the IFFIm and \$920 million through the AMC.

The Global Fund to Fight AIDS, Tuberculosis and Malaria receives resources through three mechanisms. First, voluntary contributions from (PRODUCT)^{RED}TM, which collects profits generated from products and events under the trademark (RED)TM. Second, it receives half of the value of cancelled debt under Debt2Health debt-swap agreements. And, third, it obtains contributions from UNITAID. It should be noted, however, that in the case of the Global Fund, these innovative sources of financing provide only a fraction of its overall revenues. Since 2006, (PRODUCT)^{RED}TM has transferred over \$150 million to the Global Fund.^a Under the Debt2Health initiative, the Global Fund has implemented health projects in Indonesia and Pakistan worth €45 million through two debt-swap agreements since 2007, by securing the commitment of €200 million for 2008-2010 from Germany.^b The cumulative paid-in contributions by UNITAID to the Global Fund amounted to \$130 million. The sum of revenues raised by these three mechanisms, therefore, accounts for not more than 2 per cent of the Global Fund's cumulative contributions received so far.

Further expansion of these mechanisms remains challenging. In the case of the GAVI Alliance, IFFIm commitments after 2010 are levelling off, creating an estimated funding gap of \$2.6 billion during 2010-2015. Although a few new donors have been added, GAVI would need to find additional IFFIm donors or secure larger contributions from existing donors in order to fill its financing gap. In March 2010, the GAVI Alliance did manage to secure the participation of two pharmaceutical companies in making long-term commitments to supply new vaccines under the AMC.

Progress in enhancing the Debt2Health initiative has also been slow. Debt2Health was incorporated as a permanent feature of resource mobilization for the Global Fund in November 2009, but only two new agreements have been signed so far. The two new agreements included one between Australia and Indonesia involving a debt write-off worth AS\$ 75 million, signed in July; and one between Germany and Côte d'Ivoire signed in September 2010, cancelling €19 million of the latter's debt. With these agreements, the total amount of debt swapped under this initiative is now €164 million (US\$ 213 million). While no new official donors have been added to the Debt2Health initiative, the Global Fund did manage to forge two innovative financing agreements with private agents which could yield important new revenue: it agreed with the Dow Jones Indexes to explore the creation of a new blue chip index, which could be licensed as the basis for investible products, and with the National Bank of Abu Dhabi to launch an Exchange-Traded Fund, from which the Global Fund would receive a portion of the licence and management fees.

^a See, (RED)TM, available from <http://www.joinred.com/FAQ> (accessed on 18 August 2010).

^b The Global Fund to Fight Aids, Tuberculosis and Malaria, "Debt2Health: Innovative Financing of the Global Fund", available from <http://www.theglobalfund.org/en/publications/other/debt2health/?lang=en> (accessed on 18 August 2010).

Innovative financing options are being explored for education, climate change adaptation and food security

Innovative finance mechanisms thus far have been by and large confined to supporting global health initiatives. Their usage to increase funding for other development purposes, such as education, climate change adaptation and food security, are being explored. The Leading Group formed a new task force on education, which brought out a report in September of 2010, entitled "2+3=8: *Innovating in Financing Education*". The United Nations High-Level Advisory Group on Climate Change Financing also studied

funding options, including innovative mechanisms, to raise \$100 billion per year by 2020, and presented its final report in November 2010.²⁴

As new options are being explored, questions are being raised whether innovative financing for global initiatives should not also be subjected to aid effectiveness criteria as established by the Paris Declaration. There is also criticism that new financing mechanisms are further complicating the already complex aid architecture and contributing to its further fragmentation.

Debt relief

Sovereign debt problems appeared to have become a thing of the past in mid-2008, as debt indicators of developing countries had improved remarkably, aided by several years of unhampered economic growth and debt relief for many low-income countries. However, while many developing countries were reducing their indebtedness, many developed countries were increasing their borrowing. Discussions on debt sustainability, which for decades focused on overindebtedness in low-income and emerging market countries, have now become global. Public debt in advanced countries reached about 70 per cent of GDP as at end-2007, and is projected to rise to above 100 per cent of GDP at the end of 2015.

Despite improvements in the debt positions of many developing countries prior to the crisis, some countries, including some small middle-income countries, remained in vulnerable situations; since the crisis, many more have vulnerable debt positions. The total external debt (public and private) of developing countries as a share of GDP rose to 24.8 per cent in 2009, an increase of 2.2 percentage points over the previous year. The downward trajectory of the debt service-to-exports ratio was reversed owing to the negative impact of the crisis on the dollar value of both GDP and exports. As a result, the average external debt-to-export ratio of developing countries and transition economies increased from 64.1 per cent in 2008 to 82.4 per cent in 2009. In many countries, debt ratios increased even more significantly as efforts to manage the impact of the crisis resulted in rapid increases in public debt. The public debt of a large number of developing countries is above 40 per cent of GDP, including the debt of countries that benefited from the Heavily Indebted Poor Countries (HIPC) Initiative. Many post-completion point HIPCs have increased debt to levels above the thresholds utilized for their debt writeoffs.

Gross IMF lending commitments, which stood at \$1 billion in 2007, went up to \$49 billion in 2008 and \$120 billion in 2009. IMF concessional lending commitments in 2007 amounted to \$0.2 billion, and rose to \$1.2 billion in 2008 and \$3.8 billion in 2009. Other multilateral financial institutions also sharply increased their lending levels. The World Bank increased its gross commitments from \$36.5 billion in 2007 to \$65 billion in 2009. Most of the increase was for International Bank for Reconstruction and Development (IBRD) loans targeted to middle-income countries. The main regional development banks also increased their lending from \$30 billion to \$50 billion over the same period.

Although generous debt relief has been provided to low-income countries under the HIPC Initiative, vulnerabilities remain. As at end-September 2010, after the Comoros reached its decision point in June of 2010, 36 out of 40 countries qualified for debt relief under HIPC (“post-decision point HIPCs”). Since the beginning of 2010, four countries—Afghanistan (January), the Congo (January), Liberia (June) and the

Debt problems have now engulfed developed countries also

The debt situation in many developing countries has improved, but problems remain

Despite generous debt-relief measures, a number of countries remain vulnerable

²⁴ United Nations, “Report of the Secretary-General’s High-level Advisory Group on Climate Change Financing”, 5 November 2010, available from http://www.un.org/wcm/webdav/site/climatechange/shared/Documents/AGF_reports/AGF_Final_Report.pdf (accessed on 23 November 2010).

Democratic Republic of the Congo (July)—have reached their completion points and qualified for irrevocable debt relief from the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI), increasing the number of post-completion point countries to 30. Six countries are now between their decision and their completion points (“interim HIPCs”), three of which are expected to reach their completion point within the next 12 to 18 months. Assistance committed to the 36 post-decision point HIPCs (\$127 billion, including \$51 billion under the MDRI) represents, on average, 38 per cent of their 2009 GDP. The debt burden of these countries has been reduced by more than 80 per cent on average compared to pre-decision point levels.²⁵

More funds are needed to provide debt relief to HIPCs with protracted arrears

The total cost of the HIPC Initiative is estimated at \$76.4 billion by end-2009 in present value terms (an increase of \$2.5 billion from end-2008 in present value terms), of which \$54.3 billion represents irrevocable debt relief to the 30 post-completion point countries. The estimated costs for the six interim countries and four pre-decision point countries are \$5.3 billion and \$16.9 billion, respectively. Additional HIPC assistance received so far by the six interim HIPCs represents less than 3 per cent of the total cost. In order to provide debt relief to the few HIPCs with protracted arrears to international financial institutions (IFIs), more funds will be required.²⁶

The total cost of the MDRI is estimated at \$30.3 billion at end-2009 in present value terms (an increase of 1.9 billion from end-2008 in present value terms)²⁷, of which \$26.7 billion has been delivered to the 30 post-completion point HIPCs. In addition, the IMF has also provided MDRI relief to Cambodia and Tajikistan. While the World Bank’s Debt Relief Trust Fund and International Development Association (IDA) have sufficient resources to cover debt relief costs under the HIPC Initiative over the IDA-15 commitment period (FY 2009-2011), IMF resources are sufficient to cover the costs of the remaining HIPCs, except for the protracted arrears of Somalia and Sudan, for which no provision had been made under the original HIPC financing framework. Additional resources will be needed if more countries, such as Myanmar (whose end-2004 debt data to determine eligibility are yet to be made available), become eligible for assistance under the Initiative.

More than half of the costs of non-Paris Club and commercial creditors relate to pre-decision point HIPCs

Non-Paris Club official creditors and commercial creditors account for 13 per cent and 6 per cent of debt relief, respectively.²⁸ While Paris Club creditors’ costs are mostly for debt relief to post-completion point HIPCs, more than half of the estimated costs of non-Paris Club and commercial creditors relate to pre-decision point HIPCs. The IDA and IMF estimate that non-Paris Club creditors have delivered between 34 and 39 per cent of their programmed debt relief.²⁹ Delivery of debt relief by commercial creditors has improved in recent years. Some commercial creditors continue to pursue litigation against HIPCs to recover claims. The number of litigation cases declined from 33 to 14 cases in 2009; the situation was similar in 2010, the key changes being the conclusion or withdrawal of two cases.³⁰ The limited participation of non-Paris Club official creditors in

²⁵ World Bank, “HIPC At-A-Glance Guide (Fall 2010)”, available from http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1256580106544/HIPCFA12010_ENG.pdf (accessed on 18 October 2010).

²⁶ International Development Association (IDA) and IMF, “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of implementation”, 14 September 2010.

²⁷ World Bank, *op. cit.*

²⁸ IDA and IMF, *op. cit.*

²⁹ Based on IDA and IMF, *op. cit.*, annex table 15.

³⁰ IDA and IMF, *op. cit.*

the debt relief process and litigation by commercial creditors remain obstacles to minimizing the risk of future debt-servicing difficulties of HIPC.

One positive development in the litigation cases by commercial creditors was the agreement in principle of the litigants in the two lawsuits against Liberia in April 2009 to participate in an external commercial buy-back operation, with support from the IDA Debt Reduction Facility (DRF). Another relates to national and multilateral initiatives, such as the United Kingdom of Great Britain and Northern Ireland's Debt Relief (Developing Countries) Act of April 2010 which limits the amounts that litigating creditors can recover in the country's courts against HIPCs. A member of the United States House of Representatives has also presented legislation that would limit the ability of non-participating creditors to seek awards from HIPCs via United States courts. While no legal support facility is yet available for HIPCs outside Africa, the African Legal Support Facility, launched by the African Development Bank with an initial endowment of \$16 million, is now operational to provide support for African countries facing litigation from commercial creditors.³¹

The global financial crisis has enhanced the debt vulnerabilities of many low-income countries, including HIPCs, although the IMF forecasts that systemic post-crisis debt difficulties are unlikely.³² According to the latest information from the IDA and IMF on implementation of the HIPC and MDRI initiatives, five HIPCs are classified as being "in debt distress", while eight others are at "high risk of debt distress" (figure III.3). Seven non-HIPC low-income countries are identified as facing debt problems. Two new post-completion point HIPCs, namely, the Democratic Republic of the Congo and Liberia, were classified as being "in debt distress" in the April 2010 study;³³ however, at the time of the study, both were interim HIPCs. Since then, the Democratic Republic of the Congo has exited the HIPC Initiative with a "high risk" rating,³⁴ while the most recent IMF country report dated July 2010 indicates that Liberia exited with a "low risk" rating.³⁵

Despite the debt relief already provided, the World Bank classifies almost half (19) of the 40 HIPCs as being in "fragile situations", lacking effective delivery of development finance and services.³⁶ Only a few HIPCs are on track to meet the MDGs, while progress in eradicating extreme poverty and hunger and in improving maternal health has been particularly slow. Continued and increased access to concessional financing needs to be considered if post-completion point HIPCs are to maintain debt sustainability beyond their completion points.

After the fourth extension of the sunset clause, which expired at the end of December 2006, no further extension is being considered in the light of the crisis. This means that, no matter how unsustainable their debt levels may be, developing countries

Some positive developments have occurred in the area of litigation

Only some HIPCs are on track to meet the MDGs

No further extension of the sunset clause is being considered

³¹ IDA and IMF, op. cit., pp. 20-23.

³² IMF and World Bank, "Preserving debt sustainability in low-income countries in the wake of the global crisis", paper prepared by the staffs of the IMF and the World Bank, 1 April 2010, available from <http://www.imf.org/external/np/pp/eng/2010/040110.pdf>.

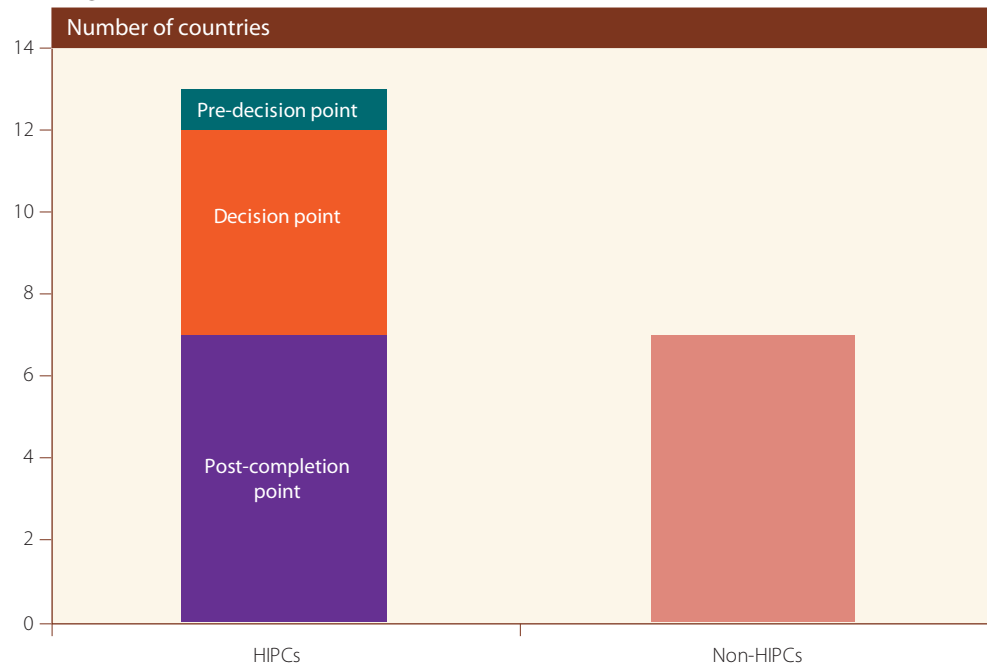
³³ Ibid., p.17.

³⁴ IDA and IMF, op. cit., p.9.

³⁵ Based on IMF Country Report No. 10/192 of 8 June 2010, "Liberia: Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document and Multilateral Debt Relief Initiative", which contains Liberia's debt sustainability analysis and concludes that "Liberia's risk of debt distress remains low following the debt relief under the HIPC initiative and the MDRI, although delays in implementing structural reforms aimed at raising growth, investment and exports could be a source of external vulnerability." (p. 55).

³⁶ IMF and World Bank, *Global Monitoring Report 2010: The MDGs after the Crisis* (Washington, D.C.: IMF and World Bank).

Figure III.3
Low-income countries in debt distress or at high risk of debt distress, October 2010



Source: UN/DESA, based on IMF, "List of LIC DSAs for PRGT-Eligible Countries, as of October 12, 2010" and IDA and IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation", 14 September 2010.

Note: Debt distress rating according to the latest DSA publication.

that did not meet the HIPC eligibility criteria in 2006 will not be able to enjoy the benefits of HIPC or MDRI debt relief despite new debt vulnerability and distress. Zimbabwe, for example, currently assessed as being in debt distress,³⁷ did not meet the World Bank's income criteria based on its end-2004 data. For the country to be eligible for HIPC debt relief, the eligibility criteria would have to be modified. Additional efforts need to be made to ensure that all eligible countries benefit under the HIPC and MDRI initiatives.

The 2009 review of the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries resulted in a change in approach towards the debt of State-owned enterprises, remittances and the growth-investment nexus. However, the review did not allay concerns about country policy and institutional assessments, whose continued inclusion in the framework have come under greater criticism. While institutions matter for long-term development, thresholds for debt-carrying capacity defined in the short- and medium-term, based on institutional quality, give greater weight to institutional and governance factors, without recognizing that improvement of these factors requires fiscal capacity. A needs-based assessment for the allocation of grants to invest in the MDGs and other development goals would therefore need to be considered so that development gains lead to improved institutional governance and debt-carrying capacity.

While the debt problems of small middle-income countries do not pose systemic risks, they reduce space for growth and development expenditure. For the majority of countries in this category, the bulk of the debt is owed to multilateral institutions. Many of these countries are beset with structural vulnerabilities and suffer from debt overhang. New borrowing in these cases would only make these economies even more indebted. Other complementary policy tools are needed in addition to official sector lending.

³⁷ IMF and World Bank, "Preserving debt sustainability", op. cit., p.17.

Further work is needed to provide the technical basis for a balance between new resources and other debt resolution tools.

The unfolding debt distress in some European countries, as well as renewed indebtedness in some developing countries, points to the limits of the existing arrangements for dealing with debt problems. There is an urgent need to set up an international sovereign debt workout mechanism which would allow countries to restructure their debt in a timely and comprehensive manner, if necessary.

Surging sovereign debt problems point to the need for an international debt restructuring mechanism

Strengthening the international financial architecture

The international community has continued its efforts to overhaul financial regulation and supervision, as well as to review the mandate of the IMF and its responsibilities for surveillance, financing and stability of the international monetary system, including the international reserve system. There have also been further deliberations on improving global economic governance and governance reform of the IFIs, with a view to enhancing their legitimacy, credibility and effectiveness.

Efforts to overhaul financial regulation and supervision are continuing

Reform of the framework for financial regulation

The financial crisis has demonstrated the urgent need to significantly improve financial regulation and supervision in order to achieve global financial stability. The June 2009 United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development called for expanding the scope of regulation and supervision and making them more effective with respect to all major financial centres, instruments and actors.

It has also been recognized that financial regulation at the microprudential level, focused on individual financial institutions, is not enough to achieve global financial stability and has to be supplemented by an adequate macroprudential framework. The reform agenda—set in motion by the G20 summits in Washington, London, Pittsburgh, Toronto and Seoul—envisages the introduction of macroprudential supervision that would take due account of the overall stability of the financial system, including pro-cyclicality, and systemic risks and moral hazard caused by systemically important financial institutions (SIFIs). Close cooperation and coordination among numerous national and international regulatory and standard-setting bodies is important to ensure coherence and consistency of reform measures and to assess the costs and benefits of the proposed changes.

Global financial stability requires a macroprudential framework

A major step in the reform process is the modification of the Basel II framework for capital and liquidity regulation. The goal of Basel III is to raise the level, quality, consistency and transparency of bank capital. Banks have already increased their capital and liquidity buffers beyond those required by Basel II following market pressures and increased scrutiny by bank supervisors after the crisis. Nevertheless, significantly higher formal minimum capital requirements are deemed necessary to help avoid any return to the low pre-crisis capital and liquidity levels when financial conditions return to normal and competitive pressures reassert themselves. The new capital and liquidity reform package, Basel III, was agreed to and issued by the Basel Committee on Banking Supervision (BCBS) between July and September 2010.³⁸

³⁸ Bank for International Settlements (BIS), "The Basel Committee's response to the financial crisis: report to the G20", October 2010, available from <http://www.bis.org/publ/bcbs179.htm>.

A higher minimum common equity requirement constitutes a key element of Basel III

A key element of Basel III is an increase in the minimum common equity requirement, to 4.5 per cent from 2.0 per cent under Basel II.³⁹ To address pro-cyclicality, in addition to minimum requirements, the BCBS agreed to introduce capital conservation and counter-cyclical buffers to be built up in good times and drawn upon in periods of stress. A capital conservation buffer of 2.5 per cent of common equity is aimed to ensure that capital remains available to support the bank's ongoing business operations during times of stress. A counter-cyclical capital buffer in a range of 0.0-2.5 per cent may be built during periods of rapid credit growth if, in the judgement of national authorities, a credit bubble has led to the build-up of system-wide risk. The buffer will be released in the downturn of the credit cycle to help absorb losses in the banking system that pose risks to financial stability.

In addition, a cap on the leverage ratio will be introduced

There is also an agreement to introduce a leverage ratio, that is to say, a cap on the amount of assets a bank may have in relation to its equity. This backstop is seen as supplementary to the risk-based capital framework. In addition, there will be higher capital charges related to bank-trading activities, complex securitizations and derivatives.

Along with more and better capital to absorb unexpected losses, the BCBS has proposed a global liquidity standard which would require banks to better match the maturities of their assets and liabilities. Another feature of this standard is the requirement for banks to hold sufficient stocks of high-quality liquid assets to allow them to survive a 30-day loss of access to market funds.

The phase-in of the new conditions will differ according to national circumstances

According to the BCBS, implementation of the main components of Basel III should be completed by the beginning of 2019. It has been agreed that phase-in arrangements for adopting the new standards should reflect different national starting points and circumstances.⁴⁰ In particular, special attention needs to be given to the characteristics, depth and capacity of local financial markets.

Higher capital requirements would force banks to raise additional capital. This may have a negative impact on banks' ability to lend and could result in somewhat slower global growth. However, according to the Financial Stability Board (FSB)/BCBS Macroeconomic Assessment Group, the reforms proposed by the Basel Committee are likely to have, at most, a modest impact on aggregate output, provided appropriate transition arrangements are in place.⁴¹

The new standards only apply to banks, while better regulation of non-banking institutions is at least as important

According to many observers, Basel III represents a substantial improvement in the quantity and quality of bank capital. It has been stressed, however, that these new capital and liquidity standards apply only to banks. Consequently, despite some progress, much more needs to be done to address risks outside traditional banks and to ensure consistency in the application of regulations across different types of financial markets and institutions offering similar products.

Furthermore, work is under way at the FSB to develop principles to reduce the reliance of authorities and market participants on credit-rating agency (CRA) ratings. The

³⁹ The minimum ratio of 2.0 per cent under Basel II is more like 1.0 per cent for an average bank in the new, stronger definition under Basel III (see, "Basel III: towards a safer financial system", speech by Jaime Caruana, General Manager of the BIS, at the Third Santander International Banking Conference, Madrid, 15 September 2010, available from <http://www.bis.org/speeches/sp100921.htm>).

⁴⁰ The G20 Toronto Summit Declaration, Toronto, Canada, 26-27 June 2010, available from http://www.g20.org/Documents/g20_declaration_en.pdf.

⁴¹ BIS, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements: Interim report", prepared by the Macroeconomic Assessment Group, established by the Financial Stability Board and the Basel Committee on Banking Supervision, August 2010, available from <http://www.bis.org/publ/othp10.pdf>.

goal is to reduce the effects of CRA ratings that amplify pro-cyclicality and cause systemic disruption.⁴²

Apart from addressing pro-cyclicality, the FSB and BCBS are developing policy approaches for addressing the “too-big-to-fail” problems associated with SIFIs. These are considered major concerns of regulatory reform, as the crisis has exposed an alarming disparity between the global activities of these banks and the constraints of mainly national regulation. The starting point is to identify systemically important institutions, size not always being the sole indication of systemic relevance. Interconnectedness, substitutability and the state of the markets are also relevant. However, there is not yet consensus on the issue.⁴³

As regards ensuring the safety and soundness of SIFIs, the introduction of the Basel III framework and the resulting improvement in the capacity of these institutions to absorb losses are considered to be only part of the solution. It has been agreed that SIFIs should have loss-absorbing capacity beyond the general standards. Proposed measures include capital surcharges and levies related to the institutions’ contribution to systemic risk, contingent capital and bail-in debt. The proposed policy framework also includes enhanced on-site supervision, harmonized enforcement activities and strengthened supervisory cooperation and coordination, including a mutual policy review process to promote consistent national policies.

Another important focus of reform is the development of legal and policy frameworks for cross-border resolution that should allow institutions of all types and sizes to fail without putting the rest of the financial system or taxpayers at risk. Given the complexity of the tasks and the different interests of the countries involved, harmonization of national wind-down rules that would allow regulators to step in promptly and in a coordinated way when problems emerge in financial institutions is a precondition for an effective resolution framework. Standards for global firms should set a common floor, while actions across countries must be sufficiently coordinated to avoid unilateral responses and regulatory arbitrage. There may also be a need in an international agreement for principles that would promote equitable outcomes on the disposition of assets and payment of the costs of resolving failed institutions. Besides, every important firm, regardless of the institution’s legal form, must be included within the parameters of such regulation.

Should attempts to create such a comprehensive framework not succeed, some alternative solutions may gain broader acceptance, including the placing of restrictions on certain business activities and on the size and structure of financial firms so as to make all institutions resolvable without adverse systemic implications.

Options to devise a fair and substantial contribution from the financial sector to fund the fiscal costs of financial failures are also being explored internationally. Initially, the discussion was centred on the imposition of levies and taxes on financial institutions. However, global bank taxation lacks the necessary support. Accordingly, it was acknowledged that there was a range of policy options, with countries pursuing different approaches.⁴⁴

“Too-big-to-fail” problems remain a major policy concern

Creating an orderly cross-border default mechanism poses another challenge for policymakers

Other options include restrictions on certain business activities

⁴² Statement of Mario Draghi, Chairman of the Financial Stability Board, at the twenty-second meeting of the International Monetary and Financial Committee (IMFC) of the IMF, Washington, D. C., 9 October 2010, available from <http://www.imf.org/External/AM/2010/imfc/statement/eng/fsb.pdf>.

⁴³ See, “The G20 agenda on financial regulation”, speech by Axel A. Weber, President of the Deutsche Bundesbank at the International Conference on Financial Market Regulation, Berlin, Germany, 19 May 2010, available from <http://www.bis.org/review/r100520a.pdf>.

⁴⁴ The G20 Toronto Summit Declaration, op. cit.

Regulation alone cannot ensure financial stability

The crisis has shown that prudential regulation alone cannot ensure financial stability and that monetary and fiscal policies also matter in helping to mitigate the build-up of financial imbalances. According to many observers,⁴⁵ besides controlling inflation, monetary policy should take better account of asset prices and credit booms. Fiscal policy must play a supporting role in a financial stability framework. While the major goal of fiscal policy is counter-cyclical demand management, it should also take into account the need to build fiscal buffers in good times to respond to financial system stress.

Multilateral surveillance and policy coordination

Surveillance needs to place greater emphasis on policy spillovers

The IMF has recognized that, unlike the outside world, Fund surveillance has not changed much since the late 1970s and is almost the same for all members.⁴⁶ The crisis, however, has forcefully demonstrated that, in a world of integrated capital markets and interconnected national financial sectors, the status quo is no longer acceptable. A key goal of reform is therefore to strengthen multilateral surveillance and enhance the coverage and depth of analysis of financial sector issues and policies. To promote global stability, the Fund's surveillance activities need to pay more attention to policy spillovers, especially those of systemically important countries. Surveillance at the country level remains fundamental, but is no longer sufficient. Assessing international coherence and promoting coordination among national policies should become a central objective of the collaboration.

According to the Independent Evaluation Office of the IMF, most members support a greater direct Fund presence in international policy coordination and spillover analysis.⁴⁷ However, the Fund's role is not well defined; it is therefore deemed useful to clarify what is expected of the Fund and its membership in order to preserve systemic stability, including key modalities, procedures and outcomes. In this regard, the International Monetary and Financial Committee (IMFC) has requested the Fund to study the cross-border implications of the policies of systemically important economies under consideration.⁴⁸ The goal of the reports is to raise the members' awareness of their responsibilities in preserving global financial stability, and to more clearly highlight the risks faced by countries affected by international spillover effects. A trial exercise with five major economies (China, the euro area, Japan, the United Kingdom and the United States) is to be completed by July 2011.

There have also been suggestions to hold multilateral consultations, as needed, on specific topics that have systemic implications, in order to foster collaboration and collective action.⁴⁹ One such topic might be growing sovereign risks of developed countries.

⁴⁵ See, for instance, "Towards a global financial stability framework", speech by Hervé Hannoun, Deputy General Manager of BIS at the 45th SEACEN Governors' Conference, Siem Reap Province, Cambodia, 26-27 February 2010, pp. 19-23, available from <http://www.bis.org/speeches/sp100303.htm>.

⁴⁶ IMF, "Modernizing surveillance mandate and modalities", paper prepared by the IMF Strategy, Policy and Review Department and the Legal Department, 26 March 2010, p. 4, available from <http://www.imf.org/external/np/pp/eng/2010/032610.pdf>.

⁴⁷ Independent Evaluation Office of the IMF, "IMF Interactions with Member Countries", Evaluation report, 25 November 2009, p. 34, available from http://ieo-imf.org/eval/complete/pdf/01202010/IMC_Full_Text_Main_Report.pdf.

⁴⁸ Communiqué of the Twenty-Second Meeting of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Press release No. 10/379, 9 October 2010, available from <http://www.imf.org/external/np/sec/pr/2010/pr10379.htm>.

⁴⁹ IMF, "IMF Executive Board discusses modernizing the Surveillance Mandate and Modalities and Financial Sector Surveillance and the Mandate of the Fund", Public Information Notice (PIN) No. 10/52, 22 April 2010, available from <http://www.imf.org/external/np/sec/pn/2010/pn1052.htm>.

Thus far, the most major attempt at the highest political level to take account of multilateral dimensions when setting national policies has been initiated outside of the IMF surveillance process. At the September 2009 Pittsburgh Summit, G20 leaders announced the Framework for Strong, Sustainable and Balanced Growth and committed themselves to submitting their actions to peer review via the Mutual Assessment Process (MAP). Through the MAP, the world's largest economies are supposed to be accountable to one another for the global coherence and consistency of their budget, monetary and structural policies. At the G20 Summit in Seoul, participants agreed to enhance the MAP through, among other things, the establishment of indicative guidelines with respect to the global imbalances.

However, there have been signs that the momentum for closer cooperation and coordination is decreasing and giving way to diverse narrow domestic agendas. Global economic prospects have been threatened by tensions over current-account imbalances and exchange-rate issues. In November 2010, in an attempt to reinvigorate commitment to cooperation, G20 leaders, at their Summit in Seoul, the Republic of Korea, made a commitment to move towards more market-determined exchange-rate systems, to enhance exchange-rate flexibility so as to reflect underlying economic fundamentals (while being vigilant of excess volatility and disorderly movements in exchange rates), and to refrain from competitive devaluation of currencies.⁵⁰ The Seoul Summit also reaffirmed its commitment to strengthen multilateral cooperation, to promote external sustainability and to pursue policies conducive to reducing excessive imbalances. In this regard, the G20 leaders noted the importance of assessing, against indicative guidelines (to be agreed upon by the G20 Finance Ministers and Central Bank Governors), the nature of persistently large imbalances and the root causes of impediments to adjustment as part of the MAP, while recognizing the need to take into account national and regional circumstances.⁵¹ However, no precise guidelines, targets or policies on how to rebalance the global economy were agreed to.

The IMF has been asked to assist the MAP by providing an analysis of how G20 member policies fit together and whether these policies are consistent with more sustainable and balanced global growth. Such technical assistance is separate from Fund surveillance. Nevertheless, it holds some promise of greater engagement by systemically important countries with the Fund, including in ways that involve the whole IMF membership. Moreover, IMF involvement in the MAP could inform discussion on surveillance reform.

The global financial crisis has revealed the critical importance of enhancing the coverage and depth of analysis of financial sector issues in Fund surveillance. To better understand and assess the risks of transmission of macrofinancial instability across countries, the Fund would need closer engagement with members with systemically important financial sectors, as well as those with large and complex financial institutions. In September 2010, the IMF Executive Board approved making financial stability assessments under the Financial Sector Assessment Program (FSAP) a regular and mandatory part of the Fund's Article IV surveillance for 25 members with systemically important financial sectors. This group of countries covers almost 90 per cent of the global financial system and 80 per cent of global economic activity.

Financial sector surveillance is not the purview of the IMF alone. There is a need for closer collaboration with the FSB, the Bank for International Settlements (BIS) and financial sector standard-setting bodies. Coordination and enhanced collaboration should

Tensions over current-account imbalances have prompted new, but vague, pledges by the G20

The crisis has illustrated the importance of including financial sector issues in Fund surveillance

⁵⁰ The G20 Seoul Summit Leaders' Declaration, 11-12 November 2010, available from <http://www.g20.utoronto.ca/2010/g20seoul.pdf>.

⁵¹ The Seoul Summit Document, available from <http://www.g20.utoronto.ca/2010/g20seoul-doc.pdf>.

help to avoid excessive duplication and to develop a division of labour and a clearer delineation of responsibilities, with each party making the most of its comparative advantage.

Current economic conditions require a reassessment of the role of measures to manage capital flows

There is also a need to revise analysis, as well as policy prescriptions, related to cross-border capital flows. Low interest rates and highly liquid conditions in developed countries, the result of monetary policy measures undertaken to forestall the crisis, have led to surges of capital flows to many emerging market economies with comparatively higher interest rates and a stronger growth outlook. Sudden inflow surges complicate macroeconomic management and may lead to inflation and asset price bubbles. There are also risks of abrupt stops or reversals in those flows. It has been recognized that, along with macroeconomic and prudential policy measures, and depending on the circumstances, the imposition of capital controls may be an appropriate response.⁵² Moreover, free flows of capital may not necessarily be preferred for emerging market and developing countries, as fully open capital accounts can be problematic.⁵³

The Fund could provide a much-needed multilateral perspective on capital flow management

To help its members deal with capital flows, and as part of its surveillance activities, the Fund will continue work to fill information gaps on cross-border capital flows and exposures and to deepen the understanding of capital flows and their interrelationships with other policy areas. This should include providing countries with pragmatic policy advice on how to limit excessive short-term flows. Moreover, on the basis of this analysis, the Fund could provide a much-needed multilateral perspective on the issue by advising both capital-exporting and capital-importing countries on the economic policy choices necessary for ensuring orderly capital flows. Such a multilateral platform for managing capital flows would be an appropriate response to the current crisis that once again underscored the capriciousness of capital flows.

Despite expanding the Fund's surveillance mandate, there is general concern that this surveillance does not have enough traction in member countries and can only be effective to the extent that members are cooperative and responsive. Going forward, the challenge is to ensure that the international community will be more willing and able to respond to global risks in a more coordinated fashion. This requires more flexibility, receptiveness and willingness by member countries to implement policy advice (and is part of membership obligations that they should clearly commit to fulfilling).

A global financial safety net

A global financial safety net would help in dealing with any liquidity crises

Alongside prudential regulation and surveillance, an effective global financial safety net is an important backstop for the preservation of global economic and financial stability. The crisis has been a powerful reminder that liquidity, both domestic and international, may dry up concurrently everywhere in the world, leading to simultaneous sharp falls in output and trade. When such a global liquidity shock occurs, public provision of liquidity should fill the gap.

The multilateral safety net was strengthened significantly during the recent crisis through \$350 billion in capital increases for the multilateral development banks, reform of IMF credit facilities and the commitment to treble IMF resources. The Fund is increasingly seen as a provider of insurance-like crisis prevention facilities in the face of volatile cross-border capital flows and risk of contagion.

⁵² See, "Macro-Prudential Policies—an Asian Perspective", closing remarks by Dominique Strauss-Kahn, IMF Managing Director, at the high-level conference in Shanghai, China, 18 October 2010, available from <http://www.imf.org/external/np/speeches/2010/101810.htm>.

⁵³ See, for instance, statement of Guido Mantega, Minister of Finance of Brazil, at the twenty-second meeting of the International Monetary and Financial Committee of the IMF, Washington, D.C., 9 October 2010, available from <http://www.imf.org/external/am/2010/imfc/statement/eng/bra.pdf>.

In August 2010, the Fund increased the duration and credit available under the existing Flexible Credit Line (FCL), an insurance option for countries with very strong policies and economic fundamentals, and established a new Precautionary Credit Line (PCL). The PCL, a form of contingent protection, is designed for those countries that do not qualify for the FCL but have only moderate vulnerabilities. Unlike the FCL, the PCL features ex post conditionalities focused on reducing any remaining vulnerabilities identified in the qualification assessment.

At its October 2010 meeting, the IMFC called upon the IMF “to continue its work on ways to improve its capacity to help members cope with systemic shocks, and to cooperate with other relevant bodies, in particular regional financial arrangements”.⁵⁴ In this regard, discussions are under way on the merits of creating a global stabilization mechanism to strengthen the Fund’s ability to channel liquidity proactively, in close cooperation with central banks, regional institutions and systemic-risk bodies, to countries that may be affected by a systemic event. A critical issue here is to find an appropriate balance and develop effective coordinating mechanisms among multilateral, regional and bilateral liquidity support arrangements.

To effectively provide a global financial safety net, the IMF needs adequate financing. In 2009, it was decided to triple the Fund’s resources to over \$850 billion. However, as a share of global GDP, this amount is still smaller than it was when the Fund was created, as the Fund’s quota-based resources have not kept pace with growth of the world economy. As a result, supporting its members during the recent crisis required recourse to bilateral loan agreements and prompted expansion of the New Arrangements to Borrow (NAB).

At their October 2010 meeting, the G20 finance ministers proposed a doubling of IMF quotas, with a corresponding rollback of the NAB. The Fund is a quota-based institution, and quotas should be its primary resource. In exceptional crisis situations, like the one recently experienced, the IMF can and should resort to borrowed resources—bilateral or, preferably, multilateral—through the expanded and enlarged NAB. The new and expanded NAB should be seen as a backstop against extreme situations and not as a major source of Fund resources. Its activation must remain the exception rather than the rule.

A broader financial safety net at the global level also includes self-protection through reserve accumulation, bilateral foreign-exchange swap arrangements between major central banks, and regional reserve pools. There have been discussions on how to improve coordination and collaboration among the IMF, central banks and regional financial arrangements in case of market stress. For instance, during the current crisis, Latin American regional and subregional financial institutions played a significant role by providing credit on more flexible conditions, particularly to help finance the liquidity needs of small countries. The ASEAN+3 Chiang Mai Initiative Multilateralization (CMIM) Agreement, covering a total of \$120 billion credit lines and developed from the Chiang Mai Initiative bilateral swap network, came into effect in March 2010. It has also been emphasized that the recent actions taken to strengthen economic and financial stability in the euro area by using a combination of insurance options may be a model for future cooperation.⁵⁵

To address sovereign risk, on 10 May 2010, the European leaders announced the establishment of a European financial stabilisation mechanism, which would entail up

The establishment of a global stabilization mechanism is being considered

A broader financial safety net will require strengthened international cooperation

⁵⁴ Communiqué of the Twenty-Second Meeting of the IMFC, op. cit.

⁵⁵ *IMF Survey online*, 11 May 2010, available from <http://www.imf.org/external/pubs/ft/survey/so/2010/NEW051110A.htm>.

to \$77 billion in European Union (EU) funding and a special-purpose vehicle that could raise up to \$568 billion in additional funds in capital markets with guarantees provided by the euro area member Governments. The IMF also agreed to cooperate with the EU if so requested by euro area members. Total available support through loans and credit lines, including potential IMF loans to member countries (up to \$284 billion), could be as large as \$930 billion. Upon request by individual countries, the IMF is ready to provide financial assistance in parallel with the EU, similar to the cofinancing already provided to Greece, Hungary, Latvia and Romania.

To address market liquidity, the European Central Bank (ECB) announced that it was prepared to purchase government and private debt securities. The ECB also expanded its liquidity provision facilities. In addition, to forestall an emerging shortage of dollar liquidity, the United States Federal Reserve (Fed) reopened temporary dollar liquidity swap lines with the ECB and other major central banks.

Incentives for individual countries to accumulate currency reserves persist

The initiatives to strengthen the global safety net are unlikely to radically change countries' incentives to accumulate reserves, which remain their first line of defence against potential shocks. Reserve accumulation has been an effective option for emerging market economies to protect them from the crisis. During the crisis, central banks in many emerging and some developed countries used part of their reserves to ease domestic tensions created by dollar liquidity shortages. It is hardly possible that, in the foreseeable future, countries will have automatic access to a sufficient quantity of foreign currency funding to cope with a major crisis. Consequently, countries will continue to hold some reserves of their own and, as discussed in chapter I, there are strong indications that reserve accumulation will persist and grow in the aftermath of the crisis. The practice of relying, to varying degrees, on a mix of complementary self-insurance and bilateral and multilateral agreements will likely continue.

The international reserve system

Much of the debate surrounding the international monetary system is centred on the sustainability of an international monetary regime in which one national currency, the United States dollar, serves as a primary international reserve asset. The current international reserve system made an important contribution in the absence of a smooth adjustment to imbalances, volatile capital flows and lopsided provision of liquidity. The need to reform the international reserve system is now broadly acknowledged.

The potential for moving to a multicurrency reserve system is limited

There have been suggestions to move towards a system based on several, competing national currencies that would perform reserve functions on a more or less equal footing. However, there are few alternatives, if any, readily available to assume a reserve role comparable to that of the United States dollar. Besides, such a system may result in even higher exchange-rate volatility owing to the possibility of sharp shifts in demand from one international currency to another, since they are likely to be close substitutes.

A more modest solution might be for countries with surplus savings to expand the range of their own safe and liquid financial assets to domestic and international investors. This would raise the efficiency of domestic financing, provide investors with a broader range of choices and reduce incentives to export capital in order to protect its value. Another option is the introduction of a new global reserve currency issued by a global central bank. The establishment of a full-fledged international currency, however, requires far-reaching changes, including relinquishment of national sovereignty over key

issues of economic policy, which the international community does not yet seem ready to make. Nevertheless, the international community should continue discussions on future needs and parameters of the financial system.

A more realistic path to reform may be to broaden existing special drawing right (SDR) arrangements which could, over time, evolve into a widely accepted world reserve currency. This may also require broadening the composition of the SDR basket to make it more representative. All component currencies, however, should be fully convertible and have well-developed financial markets. Along with reducing the inherent instability of the current system, the greater use of SDRs may result in more democratic control of global liquidity.

In August 2009, for the first time since the late 1960s, IMF member governments took a decision on a general SDR allocation by the IMF equivalent to \$250 billion. This will be complemented by a network of voluntary arrangements allowing SDRs to be traded effectively among members. Together with the special one-time allocation of about \$33 billion in September 2009, the outstanding stock of SDRs increased nearly tenfold, from about \$33 billion to about \$321 billion.⁵⁶ Nevertheless, SDRs still represent less than 5 per cent of global foreign-exchange reserves. As not all members need to increase their international reserves, the Fund should explore mechanisms for redistributing SDRs to countries most in need, especially in times of crisis. Such allocations would be cancelled once the crisis has passed. The crisis allocations should not be linked to individual country situations, but rather to systemic risk stemming from liquidity shocks on a global or regional scale.

For SDRs to take on a significant role, their issuance should be made regular, with possible linkage to expected additional long-term demand for foreign reserves. SDR use in international trade and financial transactions, as well as in a functioning settlement system to facilitate the direct exchange of SDR claims into all constituent currencies, needs to be enhanced. Thus far, a private SDR market has not taken off. Reaching a critical mass that would allow the development of a deep, diversified and liquid market for SDR instruments would likely be impossible without strong support from the public sector; actions could include some of those taken to foster the development of the European Currency Unit (ECU) market, including the issuance of SDR-denominated debt by national governments and multilateral institutions.

Additionally, SDR-denominated reserve accounts may need to be established at the IMF. These would allow large reserve holders to exchange their currency reserves for SDR-denominated securities and deposits without encountering undesirable exchange-rate effects. The resulting shift of the exchange-rate risk from the original holders of currency reserves to other parties will require agreement on an appropriate burden-sharing arrangement. This issue was discussed when the substitution account was negotiated within the IMF more than a quarter century ago.

Past experience suggests that any reform of the current international reserve system should be part of a broader framework. Indeed, it is unlikely that any feasible reform will bring about smooth and automatic balance-of-payments adjustments. For instance, while reserve alternatives would increase pressure on the United States to adjust, incentives for surplus countries would not change much. Therefore, along with moving towards greater reserve options, policy dialogue and cooperation aimed at more balanced and sustainable global growth will remain indispensable.

Expanding existing SDR arrangements could be a more practical way forward

The Fund should explore mechanisms for redistributing SDRs to countries most in need

Reform of the international reserve system should be part of a broader framework

⁵⁶ IMF, "Special Drawing Rights", Factsheet, 29 September 2010, available from <http://www.imf.org/external/np/exr/facts/sdr.htm>.

Strengthening global economic governance

Addressing global economic governance issues is a prerequisite for all other changes in the international financial architecture. The emergence of the G20 as an ad hoc governance group in response to the crisis underscores the shortcomings in global institutions and rules that were shaped, for the most part, more than 60 years ago, at the time of the founding of the United Nations. There is a diversity of views among countries regarding the increased role of the G20. Some feel that it has succeeded in averting a global depression and has managed to put the world economy on a path towards recovery. Others point out that 172 countries were left out of the process and their voices not heard.

The substitution of the G20 for the G8 is welcome but insufficient

The emergence of the G20 as the major forum for global discussions on international economic cooperation is a welcome development. However, the majority of the United Nations Member States are still excluded. The G20 process will need to develop greater legitimacy, including through forging stronger institutional linkages with non-member States and developing constructive dialogue with universal international bodies, such as the United Nations, to ensure that the views and concerns of all countries, especially the poorest, are taken into account.

Further efforts are needed to make international cooperation more transparent

An initiative aimed at developing such dialogue on coordination and cooperation between G20 and non-G20 members is the formation of the informal Global Governance Group (3G), comprising 24 United Nations Member States. The establishment of the Group underscores that, given the complexities and interdependencies of the global economy, it is important for the G20 to be consultative, inclusive and transparent in its deliberations for its outcomes to be implemented effectively on a global scale. The 3G has put forward several ideas on how to improve engagement between the G20 and the United Nations through regular and predictable channels. It has also proposed allowing non-G20 countries to participate in G20 ministerial gatherings and senior-level and expert working groups on specialized issues.⁵⁷

Achieving sustainable and balanced growth requires coordination among different policy areas

Achieving more sustainable and balanced global growth will also require close coordination of macroeconomic policy decisions with other areas of global governance, including those related to the multilateral trading system; aid architecture; the poverty eradication and sustainable development agenda; and climate change. No specific mechanism to promote coherent policy responses to these interdependent issues exists at present. A strengthened United Nations framework for enhancing coordination and complementarity should be at the centre of efforts to bridge this gap. For instance, there has been a proposal to create, within the United Nations, a global economic coordination council, which would promote development, seek consistency of policy goals and policies of major international organizations, and support consensus-building among Governments on efficient and effective solutions for global economic, social and environmental issues.⁵⁸

It has also been recognized that IFIs need more representative, responsive and accountable governance reflecting the realities of the twenty-first century. Accordingly, both the IMF and the World Bank have taken important steps to redress imbalances in voice and representation.

⁵⁷ See "Letter dated 11 March 2010 from the Permanent Representative of Singapore to the United Nations addressed to the Secretary-General" (A/64/706).

⁵⁸ See "Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System", New York, 21 September 2009, p. 91, available from http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf.

At their October 2010 meeting, the G20 finance ministers proposed a shift of over 6 per cent of aggregate quota shares in the IMF to underrepresented dynamic emerging market and developing countries, and reiterated their commitment to protect the voting share of the poorest members. As a result of the quota rebalancing, the 10 biggest members of the Fund in terms of quota will be the United States, Japan, the four BRIC countries (Brazil, China, India and Russia), and four European countries (France, Germany, Italy and the United Kingdom). The ministers also agreed to increase representation for emerging market and developing countries at the Fund's 24-member Executive Board by reducing Board membership from advanced European countries by two; to allow scope for appointing second Alternate Executive Directors to enhance representation of multi-country constituencies; and to move to an all-elected Board. It has also been suggested that, following the completion of the 14th General Review of Quotas by January 2014, the Board's composition should be reviewed every eight years. On 5 November 2010, the IMF Executive Board approved these proposals and recommended the reform package to the Board of Governors. The target date for completion of the changes to IMF governance is the IMF-World Bank Annual Meetings in October 2012.⁵⁹

The IMF Executive Board has agreed on significant reform steps

According to many Fund members, the current quota formula falls short of the objective of achieving legitimate representation in the Fund based on a country's economic weight.⁶⁰ To address the deficiencies in the present formula, the G20 ministers called for a comprehensive review by January 2013. There have been proposals to assign a greater weight to GDP, preferably at purchasing power parity prices, so as to better reflect the growing role and contribution to global growth of emerging market and other developing countries.⁶¹ Many developing countries also insist on adjustments to the measures of variability and openness.

Many Fund members view the current quota formula as being insufficient

Political will and the strong support of the entire Fund membership are necessary to translate reform commitments into reality. Indeed, the very modest 2008 IMF quota and voice reform, involving quota redistribution among the group of emerging market and developing countries, has not yet gone into effect. As of mid-August 2010, 85 out of the required 112 members, representing about 78 per cent of the total voting power (the requirement being 85 per cent), had accepted the proposed amendment to the Articles of Agreement to enhance voice and participation in the Fund.

Agreement on the second phase of governance reform for the World Bank Group was reached during the World Bank-IMF Spring Meetings in April 2010.⁶² According to the agreement, there will be a small shift in voting power to developing and transition countries in the IBRD, the International Finance Corporation (IFC) and the IDA. For the

Agreement on the second phase of governance reform in the World Bank Group has been reached

⁵⁹ IMF, "IMF Executive Board approves major overhaul of quotas and governance", Press release No. 10/418, 5 November 2010, available from <https://www.imf.org/external/np/sec/pr/2010/pr10418.htm>.

⁶⁰ See, for instance, statement of Timothy F. Geithner, Secretary of the Treasury of the United States, at the Twenty-First Meeting of the International Monetary and Financial Committee of the IMF, Washington, D. C., 24 April 2010, available from <https://www.imf.org/External/spring/2010/imfc/statement/eng/usa.pdf>.

⁶¹ Communiqué of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development, 7 October 2010, available from <http://www.imf.org/external/np/cm/2010/100710.htm>.

⁶² The initial package of reforms (Phase 1), adopted in 2008, concentrated mainly on the IBRD and included the doubling of basic votes and the allocation of authorized but unallocated shares to 16 developing countries and countries with economies in transition (DTCs) whose voting power would be reduced by the increase in basic votes. The Phase 1 reforms will increase DTC voting power in the IBRD from 42.6 per cent to 44.1 per cent. In addition, it was decided to add an elected Executive Director for sub-Saharan Africa on the World Bank Group Executive Board.

IBRD, the voting power of developing and transition countries was increased by 3.13 per cent, bringing it to 47.19 per cent (representing a total shift of 4.59 per cent since 2008). For the IFC, an increase in basic votes and selective capital increases were endorsed which represented a shift of 6.07 per cent (bringing the total to 39.48 per cent). For IDA, the voting share of developing countries would be raised from 40 per cent prior to the start of the reforms to about 46 per cent. These reform targets fall short of the recommendation of the High-Level Commission on Modernization of World Bank Group Governance that the balance in voting power in the World Bank be evenly split between developed and developing countries.⁶³

At the World Bank-IMF 2010 Spring Meetings, ministers also reaffirmed their commitment to continue moving, over time, towards equitable voting power at the World Bank, while protecting the voting power of the smallest poor countries. The next shareholding review is scheduled for 2015. Accordingly, it has been decided to establish a work programme to arrive at a dynamic formula which primarily reflects countries' evolving economic weight and the Bank's development mission. Along with the shareholding review, work is under way at the Bank on strengthening Board effectiveness and internal governance, deepening responsiveness to developing and transition countries' views on development and establishing a merit-based and transparent selection process for the Bank's President.

⁶³ See "Repowering the World Bank for the 21st Century", Report of the High-Level Commission on Modernization of the World Bank Group Governance, October 2009, available from <http://siteresources.worldbank.org/NEWS/Resources/WBGovernanceCOMMISSIONREPORT.pdf>.