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International financial system and development

Report of the Secretary-General**

Summary

The present report, submitted in response to General Assembly resolution 67/197, reviews recent trends in the international official and private capital flows to developing countries and current efforts to strengthen the international financial system. It highlights the ongoing challenges in the key areas of financial regulation, the global financial safety net, multilateral surveillance, policy coordination, management of capital flows, the governance reform of the international financial institutions and sovereign debt restructuring.

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** The present report was prepared in consultation with staff of the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations Secretariat.

I. Introduction

1. In its resolution 67/197 on the "International financial system and development," the General Assembly stressed the need for continued effort to address systemic fragilities and imbalances and to reform and strengthen the international financial system "to support sustained, inclusive and equitable economic growth, sustainable development, job creation and efforts to eradicate poverty and hunger in developing countries."

2. Although estimates of financing needs for economic, social and environmental development objectives are necessarily imprecise, studies conclude, without exception, that sustainable development financing needs are extremely large. Even if all countries meet their development commitments, official resources alone will not be sufficient to cover these needs. Nonetheless, estimated needs still represent a relatively small portion of global savings which reached around $17 trillion in 2012.[1]

3. The challenge lies in promoting a financial system that channels investments toward sustainable global development, including long-term investment in infrastructure, riskier investment in innovation and small and medium enterprises (SMEs), financing of the global commons and other areas of international cooperation, and additional financing of social needs – in a stable and sustainable manner.

4. Yet, despite recent reform efforts, there continue to be gaps, barriers, and misaligned incentives in the global financial system, which have resulted in both heightened instability and a misallocation of capital with regard to financing sustainable development needs. The sovereign debt crisis in Europe, banking system fragilities, policy uncertainty and the uneven global recovery have led to heightened risk aversion, and increased volatility of both public and private capital flows. Although global imbalances have been decreasing in recent year, significant structural issues remain.[2] Global imbalances have also been tied to massive international reserve accumulation by developing countries, at the expense of productive investment in sustainable development.

II. Reserve accumulation and global imbalances

5. A large proportion of existing global savings are currently in the form of international reserves held by central banks. From 2000 to 2012, global foreign exchange reserves increased by 468 per cent, from $2.1 trillion to $11.7 trillion, with emerging and developing countries holding an estimated $7.7 trillion and accounting for 66 per cent of the total.[3] Accumulated reserve holdings are particularly significant in South-East Asia, where they amount to almost 40 per cent of GDP.[4]

[1] IMF, World Economic Outlook 2012.
[2] UN DESA "World Economic Situation and Prospects", Chapter 1, 2013.
[3] DESA calculations based on IMF, COFER database, last quarters.
[4] Ibid.

6. Annual reserve accumulation in emerging and developing countries peaked at $1.2 trillion in 2007 prior to the crisis, but fell as a percentage of GDP in the years since (with the exception of 2010) due to the slowdown in global trade and a drop in cross-border international capital flows. Nonetheless, annual reserve accumulation is still significant, with expectations for 2013 at $635 billion.[5]

7. International reserves tend to be invested in low risk investments, with around 62 per cent of reserves currently held in US Dollar treasury securities which, despite being downgraded from AAA to AA+, are considered to be one of the safest forms of global investment. As such, foreign-exchange reserves represent a form of constrained saving, since national savings that are allocated to reserves withhold funds that could be invested in sustainable development.[6]

8. There are several reasons why countries choose to accumulate reserves. First, for many countries, reserves are a form of "self-insurance" against potential external shocks, which is a main reason why countries choose to hold reserves in extremely safe, liquid assets. Second, reserve accumulation has been the by-product of central bank interventions in foreign exchange markets to smooth exchange-rate volatility and mitigate bubbles associated with excessive capital inflows. As such, reserve accumulation has been highly correlated with global liquidity and changes in international investor sentiment. Finally, reserves can be a by-product of export-led growth strategies that maintain an undervalued currency through interventions in the currency market.

9. Empirical studies suggest that no single explanation can account for the behaviour of all countries at all times. A recent IMF study found that self-insurance provided a prominent role for the increase in international reserves following the East Asian crisis, though mercantilism in the form of an undervalued real exchange rate also appears to have contributed in some cases. The study also found a positive unexplained residual in more recent years,[7] consistent with the role of exchange rate management to smooth volatility.[8]

10. Views on the adequate size of international reserves that countries should hold have changed over time. Through the mid-1990s, it was generally believed that countries should hold enough reserves to cover three months of imports. However, the emerging market crises in the mid-1990s were triggered by difficulties in refinancing short-term dollar-denominated debt, not by pressures in the current account, which led to the view that reserves should be large enough to cover a country's short-term external debt refinancing needs. This approach did not consider, however, the emerging-market crises of the1990s were also triggered by reversals in short-term capital portfolio flows and the unwinding of

[5] IMF World Economic Outlook database, April 2013; http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx
[6] That a large share of international reserves is invested in government bonds of developed countries also implies a net transfer of resources from poorer countries to wealthier ones.
[7] Ghosh, Atish R., Jonathan D. Ostry and Charalambos G. Tsangarides, "Shifting motives: explaining the build-up in official reserves in emerging markets since the 1980s", IMF Working Paper, No. WP/12/34 (Washington, D.C., January 2012).
[8] UN DESA "World Economic Situation and Prospects", 2013.

so-called “carry trades”. By the end of the 1990s, many emerging market countries chose to engage in larger “self-insurance” against volatility associated with international capital flows and open capital accounts.

11. However, precautionary reserve accumulation, while sensible at the national level, increases systemic risk at the international level. Reserve accumulation exacerbates global imbalances, which carry the risk of a sudden and sharp disorderly adjustment process through large currency devaluations, which could lead to significant slowdowns in major economies and jeopardize hard-won development gains in developing countries.

12. To be able to reallocate reserves towards sustainable and productive investment, it is thus imperative to reduce risks in the financial system. There are several proposals that have been put forth in this regard. The Commission of Experts of the President of the United Nations General Assembly recommended that the international reserve system make greater use of IMF Special Drawing Rights (SDRs) as a way to reduce systemic risks associated with global imbalances, and as a low-cost alternative to accumulation of international reserves. SDRs would provide necessary access to foreign currency for countries experiencing capital account pressures. There have also been recommendations for mechanisms to use SDR allocations as a potential source of innovative financing for development, though care needs to be taken to preserve the role of SDRs as monetary instrument.[9] However, to date, the idea of using SDRs for development has not gained sufficient support in policy discussions.

13. Other important measures to reduce risks in the international financial system include management of international capital flows and reducing capital market volatility, reducing systemic risks associated with the banking and shadow banking systems, increasing the predictability of ODA, reducing systemic implications of associated with sovereign debt crises, and strengthening global social safety nets, as discussed in the following sections of this report.

III. International private financial flows to developing countries

14. Given the large financing needs, private investment will be crucial to achieving sustainable development objectives. Economic literature generally shows a clear correlation between investment and growth,[10] with international investment an important instrument for countries with insufficient savings to meet sustainable development needs. However, much of the literature does not distinguish between short and long-term investment.

15. Foreign direct investment (FDI) remains a major component of private capital flows to developing countries. FDI also has the potential to advance economic

[9] UN DESA “World Economic and Social Survey”, 2012.
10 R. Levine, “Finance and Growth: Theory and Evidence,” in Handbook of Economic Growth, ed. P. Aghion and Durlauf, Amsterdam: North-Holland Elsevier, 2005.

development in a number of ways, including through generating knowledge spillovers.[11] However, much of cross-border portfolio flows to developing countries has been speculative and short-term oriented. There is significant evidence that such short-term volatile capital flows complicate macroeconomic management, may lead to exchange rate overshooting and asset price bubbles, and carry risks for economic stability. Furthermore, sudden withdrawals of capital due to heightened global risk aversion can contribute to spreading financial crises, and paradoxically, to a decline in long-term investment.[12]

16. The increasing volatility of cross border capital flows is reflected in recent trends in net private capital flows to developing countries. These flows collapsed during the financial crisis, more than doubled from $206 billion in 2008 to $510 billion in 2010, and then contracted again in 2011 to approximately $393 billion. Estimated levels for 2012 are sharply lower at $51 billion. However, this sharp decline is mostly due to a large swing in other net investments (comprising mainly commercial bank flows) to China which went from a surplus of about $27 billion in 2011 to an estimated deficit of $310 billion in 2012.[13]

17. Portfolio equity flows have been an important source of the volatility in private capital flows. Equity flows fell in the latter half of 2011 due to concerns on the sustainability of public finances in Europe, which led to a general 'flight to safety', as well as worries over an economic slowdown in leading emerging economies such as Brazil, China and India, before increasing in the first part of 2012 on a more favourable growth outlook, and then falling again. In mid-2013, speculation regarding a possible slowing of quantitative easing by the US Federal Reserve led to large redemptions from emerging market equity funds and significant capital outflows.[14]

18. Bond portfolio flows (both foreign and local currency) have generally been steadier, driven in part by improved fundamentals in a number of economies, but also by aggressive monetary easing in advanced economies. In particular, weakness in developed economies and extremely high global liquidity has depressed yields in some developed countries to close to zero. A 'search for yield' by some international investors led to capital inflows in developing country markets with higher local interest rates.[15] However, the speculation on a slowing of quantitative easing led to a sell-off in emerging market bond markets, as well as volatility in domestic interest rates, which risk impacting long-term direct investment in the real economy.

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[11] However, public policies are often necessary for effective spillovers. See the Report of the Secretary-General on "Follow-up to and implementation of the Monterrey Consensus and Doha Declaration on Financing for Development", August 2013 (forthcoming).

[12] Joe Stiglitz, Ocampo JA, Spiegel S, and others (2006). Stability with Growth: Macroeconomics, Liberalization and Development. New York: Oxford University Press.

[13] IMF World Economic Outlook (WEO) Database, April 2013 and UNDESA calculations. The IMF categorization of "Emerging and Developing Economies" differs from UN DESA's categorization of "Developing Economies" in terms of countries included. Hence, the figures on net private financial flows to developing countries are different from those published by the IMF on emerging and developing economies in the WEO.

[14] UN DESA "World Economic Situation and Prospects: Monthly Briefing", 9 July 2013

[15] IMF Global Financial Stability Report, April 2013.

19. Commercial bank flows to developing countries have been the most volatile form of capital inflows, due to deleveraging of international banks, especially in Europe, which is expected to continue in the near term.[16] Of particular concern is evidence that long-term financing from banks has been constrained during the past few years. For example, the total international claims of European banks with a maturity of over two years have been falling and there are, moreover, indications that these institutions have been reallocating lending in emerging market and developing economies towards shorter maturities.

20. There is also evidence that institutional investors, including those with longer-term liabilities (such as pension funds, life insurers and endowments), have in recent years shifted asset allocations toward more liquid assets and shorter-term investments.[17] Even FDI flows, which tend to be longer term and more stable than other components of private capital flows, may be becoming more volatile. It has been argued that there has been a shift in the composition of FDI, from equity to debt components, which has made it easier to move between host and home countries.[18]

21. Conventional approaches to managing cross-border capital flows focus on macroeconomic policies, including the adoption of exchange rate, monetary and fiscal policies to enhance an economy's capacity to absorb the inflows. However, these policies may not be sufficiently targeted to stabilize financial flows and may have undesired side-effects. For instance, fiscal and monetary tightening to avoid overheating can affect economic growth prospects, while currency appreciation can harm export industries. Attempts by policymakers to counteract the expansionary impact of excessive capital inflows through tightening monetary policies could be partly self-defeating as the higher interest rates may induce additional capital inflows, thus exacerbating upward pressure on the exchange rate, and further limiting domestic policy space.

22. Instead, a number of emerging economies (including the Republic of Korea, Thailand, Brazil, Peru, Indonesia, Taiwan Province of China) have recently undertaken measures to manage inflows through direct and indirect regulations on the capital account. These measures have included macro-prudential measures, management of domestic capital markets (including derivative markets), and direct measures on capital account transactions.

23. The majority of the new initiatives have been implemented through macro-prudential policies aimed at limiting the build-up of systemic risks, such as currency mismatches and credit bubbles due to cross-border flows, through the banking system. Examples of these measures include the Republic of Korea's levy of up to 0.5 per cent on banks' non-deposit foreign currency liabilities aimed at reducing cross border short-term bank lending and Peru's increase in the marginal reserve requirements for short-term local currency deposits from 65 per cent to 120 per cent aimed at reducing short-term capital

[16] "Long-Term Investment Financing for Growth and Development: Umbrella Paper". Prepared by World Bank staff with inputs from staffs of OECD, IMF, UNCTAD, UN-DESA, World Bank Group, and the Financial Stability Board. Presented to meeting of G20 Ministers of Finance and Central Bank Governors, February 2013.
[17] World Economic Forum, "The Future of Long-term Investing", 2011.
[18] UNCTAD, "World Investment Report", 2011.

invested in Peruvian Sol interest rates (often funded in US Dollar to take advantage of interest rate differentials).[19]

24. According to research by the IMF based on emerging economies' experiences over the past decade, such macro-prudential measures have had mixed results.[20] While they appear to have lengthened the maturity of capital inflows in some countries (such as Peru and the Republic of Korea), the effect on total net flows was limited. Macro-prudential measures also tend not to be sufficiently targeted to the source of the shocks, which might limit their effectiveness.

25. In recent years, a few countries have introduced direct controls on capital inflows, including Brazil and Indonesia. Similar to macro-prudential regulations, direct controls can be price based, in the form of levies or taxes on capital inflows, or quantity based, in the form of direct limits. For example, in 2010 Brazil increased its tax on fixed-income foreign investment to raise the cost of speculation[21] (though the tax has since been cut), while Indonesia imposed a six-month holding period for Bank of Indonesia certificates to limit short-term hot money inflows.[22] Most new regulations have been imposed on limiting inflows, though regulations have also been used on outflows, such as Malaysia's controls in 1998.

26. Most available studies find that price-based capital controls on inflows have also been effective in changing the composition of inflows away from short-term debt.[23] For example, between 1991 and 1998, price-based controls on inflows in Chile appeared to have been effective in altering the composition of inflows, with short-term debt declining as a proportion of total liabilities while the stock of FDI increased from about 34 per cent to 53 per cent.[24] The impact on the volume of flows is however more ambiguous, with regulations appearing to have been more successful in some cases than in others. The varying results of similar mechanisms across countries and times suggest that there is no one-size fits all solution. The design of regulations needs to take into account the specific circumstances of individual countries, including the economic situation, existing institutions and the regulatory framework, and the structure and persistence of inflows.

27. One reason often cited for why controls might not be effective is the risk of evasion.[25] In particular, capital account regulations may be particularly difficult to implement in countries where there is a large derivatives market, since speculators can often circumvent the restrictions through this market. For this reason, some countries, like Brazil and South Korea, implemented restrictions directly in the derivatives market, albeit

[19] UN DESA, "World Economic Situation and Prospects", 2012.
[20] "Managing Capital Inflows: What Tools to Use?". IMF Staff Discussion Note, April 5, 2011, SDN/11/06.
[21] UN DESA, "World Economic Situation and Prospects 2012".
[22] "Indonesia pre-empts capital flow reversal". Financial Times, 14 April 2011.
[23] UN DESA "World Economic Situation and Prospects 2012".
[24] Jonathan D. Ostry and others, "Capital inflows: the role of controls", IMF Staff Position Note, SPN10/04 (Washington, D.C., February 2010).
[25] S. Spiegel, "How to Evade Capital Controls, and Why They are Still Effective", Pardee Task Force on Managing Capital Flows for Long-Run Development, Boston University, forthcoming, 2012.

at relatively low initial rates. Both countries also adjusted these and other controls counter-cyclically in response to changes in investor sentiment. For example, the Republic of Korea tightened limits on domestic and foreign banks' exposure to foreign exchange derivatives towards the end of 2012 in an attempt to stem volatility in the rapidly appreciating won.[26] On the other hand, Brazil eliminated its 1 per cent tax on derivatives transactions when foreign inflows fell in June 2013.[27]

28. The IMF has framed an institutional view on the liberalization and management of capital flows, which suggests that capital flow management measures, including capital controls, can be useful at times, particularly when the room for macroeconomic policy adjustment is limited, when needed policy steps or macroeconomic adjustments require time, and when inflow surges raise risks of financial system instability. These measures should not substitute for adjustments in macroeconomic policies, though the exact sequencing of the different policies, and the composition of the policy mix will depend on country-specific circumstances. The IMF's institutional view also suggests that these measures should be transparent and targeted, temporary, and non-discriminatory to the extent possible.[28] However, where there are risks to financial stability, the view does not rule out the possibility of using long-standing measures. Some experts have also argued that such regulations should be an essential part of the macroeconomic policy toolkit to combat capital flow surges before they lead to bubbles, and as such should be seen as permanent tools that can be applied counter-cyclically to changing economic circumstances.[29]

29. From a longer-term perspective, it is necessary for countries to mobilize stable domestic sources of finance and to develop deep and robust financial systems to safely intermediate external flows. This will require sustained GDP growth, a strong enabling environment and improved governance. The development of local currency bond markets is often seen as one instrument for longer-term finance, though efforts need to be made to ensure that these markets do not attract 'hot' short-term oriented funds. The development of domestic long-term investor bases should also be encouraged, such as the development of local pension markets, in conjunction with incentives to encourage long-term investment horizons.

30. In addition, efforts to reduce volatility of capital flows should also be made in the source countries. Given the cross-border spill-over effect of monetary policy decisions, measures that incentivize investors in developed countries to invest at home would help monetary authorities respond to slowdowns in developed countries and also help allay pressures for asset bubbles in developing countries. In addition, better international coordination of monetary policies and better management of global liquidity is needed to reduce global risks. Consideration also needs to be given to incentivizing longer-term

[26] "South Korea tightens derivatives limits". Financial Times, 27 November 2012.
[27] "Brazil Scraps Tax on Currency Derivatives to Stem Real Drop", Bloomberg News, 12 June 2013.
[28] "The Liberalization and Management of Capital Flows: An Institutional View", IMF, 14 November 2012.
[29] "Regulating Global Capital Flows for Long-Run Development", Pardee Center Task Force Report, Boston University, March 2012.

investments by bankers and institutional investors, which necessitates reforms in international financial regulations.

IV. Strengthening international financial regulation

33. The primary role of the financial system is to allocate savings to productive purposes. For the financial system to perform its role effectively, regulatory and other policy measures need to: (i) secure the safety and soundness of financial institutions and the financial system at large; (ii) ensure competition; (iii) protect consumers; (iv) ensure that the financial sector promotes macroeconomic stability and growth; and (v) promote access to credit and other financial services.[30]

34. The importance of many of these factors was underscored during the financial crisis. In particular, there has been an increased awareness of the need for macroprudential regulations that focus on systemic risks, including the impact of regulations on macroeconomic stability. For example, Basel III incorporates some elements to address procyclicality and reduce systemic risks, including a maximum leverage ratio and a countercyclical buffer,[31] though these are limited in scope. In addition, the Group of 20 (G20) has requested that the FSB, IMF and BIS to work on establishing a macroprudential policy framework to identify and monitor systemic financial risk and macroprudential instruments, the outcome of which is still pending. In addition, the crisis emphasized the importance of comprehensive regulations, inclusive of shadow banking.

35. Since the crisis, the international community has taken important steps to address vulnerabilities in the financial sector through regulatory reform. However, regulation has still focused primarily on ensuring the safety and soundness of the financial system, centred on the banking sector through Basel III, without giving sufficient attention to the other important criteria for a well-functioning financial sector. For example, while it’s too early to estimate the full effects of Basel III, there is a concern that the Basel capital adequacy rules, by raising the cost of lending, might have the effect of limiting riskier lending including access to finance (since smaller entities, such as micro-enterprises and SMEs, have higher capital costs). Similarly, Basel III risks further reducing the availability of long-term financing, with a particularly negative impact on developing countries that have large infrastructure needs. It also penalizes lending in areas without sufficient data on default histories, such as trade finance and new technologies, including green investments.[32]

36. There are also concerns that tighter bank regulations, in conjunction with the complexity of the Basel III framework, might trigger a new wave of regulatory arbitrage.

[30] “Principles of Regulation.” Presentation given by Joseph E. Stiglitz at the Initiative for Policy Dialogue, Financial Markets Reform Task Force Meeting, 25-27 July 2006, Manchester, United Kingdom. http://policydialogue.org/events/meetings/financial_markets_reform_task_force_meeting_manchester_2006/materials/

[31] “Macroprudential Policy Tools and Frameworks”. Progress Report to the G20 by FSB, IMF and BIS, 27 October 2011.

[32] For a discussion of trade finance in Basel III, see UN DESA “World Economic Situation and Prospects 2013”.

It is reported that new products are already being created to circumvent the rules.[33] More generally, complex regulations can be difficult to administer and costly, which argues for broad-based simple regulations that incorporate both balance sheet and off-balance sheet exposures, such as high capital ratios and low leverage ratios, with simple countercyclical rules built in. Nonetheless, there would still be a risk that activities that require higher capital would shift from the regulated banking system to shadow banking practices.

37. The value of shadow banking assets has risen from an estimated $26 trillion in 2002 to $67 trillion in 2011, or 24 per cent of total assets in the global financial system.[34] Entities such as money market funds, hedge funds and structured investment vehicles provide alternative market-based sources of funding, but also pose significant risks to the financial system. The FSB has formulated some principles for regulating shadow banking. Since most of these entities gain leverage through the formal banking system, the FSB recommendations focus on regulated banks' interactions with shadow banking entities.

38. Another area that has received global attention is 'too big to fail' institutions. During the global financial crisis, large financial institutions, in particular, were found to have spread systemic risks. The IMF estimates the implicit subsidy to big banks in terms of lower borrowing costs to be about 0.8 percentage points.[35] G20 leaders have agreed to strengthen the oversight and regulation of global systemically important financial institutions (G-SIFIs), focused on minimizing the adverse impacts their distress or failure might have on the financial sector as well as on the broader economy. The FSB has suggested that G-SIFIs have a loss-absorbing capacity beyond the general standards of Basel III, that G-SIFIs develop recovery and resolution plans, and that countries prioritize this in national regulatory frameworks.

39. Although authorities in several countries have made efforts to develop resolution strategies consistent with the FSB's recommendations,[36] further legislative measures would be necessary to fully implement the requirements and put in place arrangements for cross-border cooperation on resolution measures. In this regards, EU finance ministers recently reached agreement on the parameters of a draft directive on bank recovery and resolution for the EU, the implementation of which will be significant since the EU is home to a number of G-SIFI.[37] Measures to decrease financial concentration could also be explored, including steps to reduce the size of financial conglomerates by separating different business lines and creating a more competitive banking system.

[33] IMF "Global Financial Stability Report", October 2012.
[34] UN DESA "World Economic Situation and Prospects 2013".
[35] "The Global Financial Sector – Transforming the Landscape". Speech by Christine Lagarde, Managing Director, IMF, at Frankfurt Finance Summit (19 March 2013).
[36] "Implementing the FSB Key Attributes of Effective Resolution Regimes – how far have we come?" Report to the G20 Finance Ministers and Central Bank Governors on progress in reforming resolution regimes and resolution planning for globally systemically important financial institutions (G-SIFIs), FSB, 15 April 2013.
[37] In June 2013, European Union finance ministers agreed the parameters for a draft of the directive on bank recovery and resolution. "Answering five questions on recovery and resolution", Financial News, 27 June 2013. See http://media.efinancialnews.com/story/2013-06-27/five-questions-on-the-recovery-and-resolution-directive.

40. Progress on reform of the derivatives market has also been slower than desirable. To reduce risks in the derivatives market, the G20 agreed that over-the-counter (OTC) derivatives that can be standardized should be traded on formal exchanges or electronic platforms by the end of 2012. In addition, improvements in OTC markets should include reporting requirements and central clearing of transactions. While progress has been made toward meeting the G20 commitments through legislation, regulation and expansion of infrastructure, much remains to be done to complete the agreed reforms.[38]

41. Other regulatory initiatives under discussion include work on uniform global accounting standards, reduction in the reliance on credit rating agencies, reform of some compensation practices and the establishment of macro-prudential regulatory frameworks and countercyclical buffers. Taken together, these reforms represent important improvements that reduce risk in the financial system. However, implementation, supervision, and enforcement remain crucial. Furthermore, significant gaps remain, particularly in aligning incentives with long-term investment for sustainable development.

42. In terms of implementation, there have also been delays by some countries in meeting the 1 January 2013 agreed deadline for implementation of Basel III.[39] There is some concern that different rates of implementation could contribute to dilution of minimum standards.[40] Indeed, one goal of Basel III was to create a globally consistent and harmonized regulatory structure as a way to ensure a level playing field. At the same time, given diverse national structures, the challenge is to strike the right balance between ensuring an international level playing field and accommodating country differences, in order not to place an unnecessary burden of adjustment on national financial systems.

43. One of the primary goals of an effective financial system, which has not been fully incorporated into the reform agenda, is the importance of access to finance and financial services for all. There is no one-size fits all approach for building an inclusive financial system. Some countries have placed priority on building a nation-wide electronic payment system, while others have focused on access to credit for SMEs, and still others have focused on the need to improve the quality of usage, financial education and consumer protection. In all cases, coordination between a wide array of public and private actors is vital to arrive at a regulatory framework conducive to inclusive finance.

44. The development and adaptation of international financial regulation would also benefit from greater representation and participation of developing countries in the regulatory reform process. Despite some progress, formal representation in international financial regulatory bodies, such as the Bank for International Settlements, the Basel

[38] FSB Press Release, "FSB reports to G20 on progress of financial regulatory reforms" (19 April 2013).
[39] Fourteen member jurisdictions have issued final Basel III-based capital regulations, and 11 of them now have final Basel III capital rules in force (FSBPRR April 2013). Five jurisdictions (comprising 10 member countries) have published their draft regulations. To maintain a level playing field and prevent arbitrage, the Basel Committee on Banking Supervision (BCBS) is assessing both the consistency of national regulations with the Basel III agreement and the consistency of the outcomes on banks. (FSB, April 2013).
[40] "The Global Financial Sector – Transforming the Landscape". Speech by Christine Lagarde, Managing Director, IMF, at Frankfurt Finance Summit (19 March 2013).

Committee and the FSB, is limited to advanced economies and some major emerging market economies.

V. Official development assistance

45. Similar to changes in private financial markets, the landscape of international financial and technical cooperation has changed significantly in the years since the financial crisis. In marked contrast to the first decade of the millennium, official development assistance (ODA) has been falling in real terms for two consecutive years, and budgetary pressures in many donor countries indicate that aid levels may stagnate in the medium term. Similarly, efforts to increase the effectiveness of aid have so far yielded only modest results. At the same time, South-South cooperation has expanded rapidly, but so far remains a small fraction of ODA and should not be seen as a substitute for traditional aid. In addition, given the increasing recognition of the vast financing needs for sustainable development, there is increased interest in the role of public resources in leveraging private financing for public goals. Domestic resource mobilization including the global fight against tax evasion and avoidance are also important factors in this respect.

46. These changes have had an impact on the role of official assistance in global development goals. Similar to the scope of public finance in national economies, international public finance should have redistributive, allocative and stabilizing purposes. First, it should help meet global development goals, such as eradicating poverty. Second, it should address market failures and facilitate the public provision of goods that the private sector does not provide sufficiently (e.g. financing of the global commons). Third, it should contribute to international financial and macroeconomic stability, such as providing a global safety net through IMF facilities. The changing landscape of international cooperation suggests that while the need for ODA as a tool for poverty alleviation and meeting development goals has lost none of its urgency, the allocative role of international public finance, in terms of leveraging private resources, will become increasingly important.

47. ODA will remain critical, especially for least developed countries that have large financing needs to meet internationally agreed development goals, including the Millennium Development Goals (MDGs), but lack domestic savings or access to international capital markets. For this reason, renewed commitments are needed by major donors to reverse the decline in ODA and to increase disbursements by 2015.

48. Members of the Development Assistance Committee (DAC) of the OECD provided $125.6 billion in net ODA in 2012, which was 4.0 per cent lower than in 2011 in real terms. In addition, aid is increasingly directed to middle-income countries, and away from those countries with the largest MDGs implementation gaps. Aid to sub-Saharan Africa declined by 7.9 per cent in real terms, to $26.2 billion, and aid to the Least Developed Countries (LDCs) fell by 12.8 per cent in real terms, to about $26 billion. ODA is also expected to stagnate over the medium term. The most recent DAC Survey on donor forward spending plans for country programmable aid (CPA) expects that gross receipts by

developing countries will increase in real terms in 2013, but will remain flat over the years 2014 to 2016.

49. Budget cuts in donor countries have also had a negative impact on aid predictability, which is critical for aid effectiveness. The DAC Survey finds that donors disbursed 5 per cent less aid than planned in 2010 and 8 per cent less in 2011. This is a marked deterioration from 2009. Overall, the track record on the implementation of the Paris Declaration principles on more effective aid is disappointing. At the global level, only one out of 13 adopted targets has been met, although progress has been made towards achieving many of the remaining targets, especially on indicators where responsibility lies primarily with developing countries.

50. At the same time, several non-DAC donors, including Turkey and the United Arab Emirates, have dramatically scaled up aid. This reflects the increasingly important role of South-South development cooperation, which also involves trade, loans, technology sharing and direct investment. South-South development cooperation usually does not contain explicit policy conditions, but is sometimes focused on investments and not necessarily dedicated to poverty alleviation or fulfilling social needs. It is estimated that South-South development cooperation has reached between $12.9 billion and $14.8 billion by 2010, and it is expected to increase further, with major increases planned by China, India and Venezuela. Expanding South-South cooperation may help to cushion the fall in aid receipts from traditional donors, but nonetheless should not be seen as a substitute for traditional aid flows.

51. As environmental degradation and climate change have become increasingly urgent, climate financing has taken centre stage. However, despite significant synergies with other areas of financing for sustainable development, to date, climate financing has largely evolved on a separate track from conventional development finance. It will need to be scaled up and better incorporated into the broader global framework for financing for sustainable development in the coming years, while ensuring that new funds for climate finance are additional to existing ODA commitments.

52. New and innovative sources of finance can make a key contribution. The 2012 United Nations *World Economic and Social Survey* estimated that around $400 billion to $450 billion per year could be raised through international taxes on financial transactions and on carbon emissions, and through the use of IMF’s Special Drawing Rights (SDRs). However, it is important to ensure that these resources are additional to existing ODA.

53. At the same time, it is clear that official financing will be insufficient for the necessary long-term investments in infrastructure and technology, riskier investments such as low-carbon and innovation, and protecting the global commons. There are a number of ways in which the official sector can complement and leverage private finance, including through direct financing, co-financing, risk mitigation tools such as guarantees, capacity building and other advisory support initiatives that enhance project development, and other measures to enhance the investment climate. Such mechanisms can be implemented

at the global, regional, or national levels. As such, multilateral, regional, and national development banks can play important roles.

54. Ultimately, countries should aim to achieve the levels of domestic resource mobilization needed for development. In this respect, a fair and effective domestic tax system is central. For resource-rich countries, transparency in the extractive industries is pivotal in ensuring that economic activities by multinational entities (MNEs) are taxed appropriately, and that public revenue is spent on sustainable development. International efforts should focus on curtailing illicit financial flows including cross-border tax avoidance and evasion and transfer mis-pricing. The most recent G20 decision reiterates the importance of information exchange in enabling developing countries to collect taxes owed to them.[41] Other positive developments in this area, such as on-going OECD work on Base Erosion and Profit Shifting (BEPS) as well as efforts in other international fora such as the World Bank Group (WBG), UN and IMF should ensure that such processes be accessible and beneficial to all countries, especially developing countries.

VI. Multilateral reform

A. Global financial safety nets

55. The capacity of the multilateral system to provide liquidity in times of systemic crises is an important element in ensuring global financial stability. A reliable global financial safety net could also reduce the incentive for countries to accumulate reserves as self-insurance against adverse shocks.

56. The IMF has made several reforms to its lending facilities, aimed at increasing the flexibility of its financial arrangements. The new flexibility in the Fund's lending framework seeks to allow for more effective responses to the varying circumstances of member countries. For example, the Fund has introduced several facilities since the crisis, including the Flexible Credit Line (FCL), which provides large and up-front access to IMF resources for members with very strong fundamentals and institutional policy frameworks, and a track record and commitment to implementing very strong policies.[42] Another new facility is the Precautionary and Liquidity Line (PLL), which provides financial support to countries with sound policies but moderate vulnerabilities,[43] with focused ex-post conditionality to address these remaining vulnerabilities. In addition, the Fund's instruments for emergency assistance were consolidated under the new Rapid Financing Instrument (RFI), which may be used to support a range of urgent balance-of-payments needs without the need for a full-fledged Fund program.[44]

[41] Lough Erne Declaration available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207543/180613_LOUGH_ERNE_DECLARATION.pdf
[42] FCL factsheet at http://www.imf.org/external/np/exr/facts/fcl.htm.
[43] PLL factsheet at http://www.imf.org/external/np/exr/facts/pll.htm.
[44] RFI factsheet at http://www.imf.org/external/np/exr/facts/rfi.htm.

57. The Fund has also refined the overall lending framework for low income countries (LICs) to increase the flexibility of existing instruments, including relaxing timing restrictions on access under the Standby Credit Facility (SCF), providing options for Extended Credit Facility (ECF) arrangements with longer initial durations, increasing flexibility in the phasing of disbursements, and easing the Poverty Reduction Strategy (PRS) documentation requirements for ECF and Policy Support Instrument (PSI). In addition, the Rapid Credit Facility (RCF), created under the Poverty Reduction and Growth Trust (PRGT), provides a disbursement with limited conditionality for LICs. Given the global interest rate environment, with interest rates close to zero in many countries, a new interest rate mechanism was introduced to ensure the concessionality of Fund financing to LICs. In this context, temporary interest relief was also approved by setting at zero the interest on all concessional loans until end-2014.

58. The challenge ahead is to preserve the Fund's ability to provide financial support to LICs in the face of a prospective drop in the Fund's concessional lending capacity after 2014, especially in the PRGT's lending. In September 2012, the IMF Executive Board approved a partial distribution of the general reserves attributed to gold sales profits, which aimed to make the Poverty Reduction and Growth Trust (PRGT) sustainable in the longer term.

59. Altogether, the international financial safety net has continued to evolve towards a multilayered structure comprising global, regional and bilateral components.[45] For example, the bulk of liquidity needed to ease funding pressures during the financial crisis was provided through a series of ad hoc arrangements among key central banks. The involvement of major central banks will remain pivotal for a functioning and sufficient global financial safety net. Calls for the creation of a more permanent framework of liquidity lines between key central banks should therefore be given consideration.

60. Regional Financing Arrangements (RFAs) can play an increasingly important role in the global financial safety net. RFAs have an advantage of close ties between borrowers and lenders that may allow provision of support to countries and boost program ownership. An important development in this area was the establishment of the European Stability Mechanism (ESM) in October 2012, which replaced two earlier temporary EU funding mechanisms, and to date has approved two Financial Assistance Facility Agreements (FAFAs) with Spain and Cyprus. Enhancing cooperation and increasing complementarities between the IMF and RFAs is important for global financial stability and sustainable growth. The G20 Principles for Cooperation between the IMF and RFAs, and the IMF's stocktaking paper on its engagement with RFAs may provide a basis for enhanced cooperation.

61. However, there continues to be a lack of a global mechanism ensuring the swift and sufficient availability of substantial resources to stabilize market conditions in times of systemic liquidity crises. Efforts to further strengthen crisis-lending facilities should

[45] Pradumna B. Rana, "The evolving multi-layered global financial safety net, role of Asia", S. Rajaratnam School of International Studies, Singapore Working Paper No. 238, 16 May 2012.

therefore focus on enhancing the different layers of the financial safety net as well as strengthening the coordination and consistency between the mechanisms at different levels. A key element in strengthening the global financial safety net is closer cooperation between the IMF, national central banks and regional and sub-regional mechanisms. In this regard, a stronger role for the IMF in the coordination and management of the various layers of the global financial safety net system might be envisaged.

B. Multilateral surveillance and policy coordination

62. In recent years, the IMF has taken important steps to strengthen the quality and coverage of its surveillance activities, putting more emphasis on cross-border and cross-sectoral linkages, and paying closer attention to the spillover effects of economic policies in the world's largest economies and linkages between the financial sector and the real economy. The latest Triennial Surveillance Review (TSR), completed in October 2011, found that IMF surveillance remained fragmented, with lack of depth in risk assessments and insufficient focus on interconnections and transmission of shocks. In response to this review, the Fund implemented the Integrated Surveillance Decision (ISD) in January 2013, which strengthened the legal framework for surveillance.[46] The ISD makes Article IV consultations an instrument not only for bilateral surveillance but also for multilateral surveillance, and allows for discussions on the full range of spillovers from member countries' policies on global economic and financial stability. The ISD further defines, for the first time, the scope and modalities of multilateral surveillance, including a framework for potential multilateral consultations.

63. Multilateral surveillance was further enhanced by a pilot External Stability Report on the world's largest economies, which expands the IMF's external stability assessments beyond exchange rates, to include a broad and multilaterally consistent analysis of the external sector for the world's largest economies. In light of increasingly interconnected economies and financial systems, such in-depth periodic external sector evaluations are a critical aspect of multilateral surveillance. In addition, developing countries have emphasized that the effectiveness of surveillance depends on the quality and even-handedness of the analysis and advice provided.

64. The IMF has also increased its focus on the impact of risks emanating from the financial sector on global stability. A new Financial Surveillance Strategy lays the foundation for developing a unified macrofinancial framework that takes account of the interdependencies of financial sectors and of linkages and interactions between macroeconomic and macroprudential policies in the medium term.

65. The evolving international architecture of multilateral surveillance and policy coordination is based on the close collaboration among the IMF, the G20, the Financial Stability Board, and standard-setting bodies. An example is the G20/IMFC Data Gaps Initiative, which aims to improve the timeliness and accuracy of information on global systemically important financial institutions. The G20 Russian Presidency proposes to

[46] "IMF Surveillance", IMF FACTSHEET (http://www.imf.org/external/np/exr/facts/surv.htm).

work towards further strengthening the IMF surveillance framework and multilateral analysis, including further work on global liquidity indicators, among others.

66. However, global policy coordination remains ad hoc and piecemeal, and largely within the purview of global groupings such as the G20. Recent efforts within the G20 to strengthen policy coordination among the world's major economies are important steps forward. However, the achievement of global development goals, calls for strengthened policy coherence and coordination among all partners in global development cooperation, and macroeconomic coordination should take into account countries' development needs. While the G20 represents most of the world's population and economy, it excludes many countries, particularly small States, and doesn't represent the world's poor and most vulnerable citizens. Multilateral discussions should be institutionalized within the multilateral system, as part of a stronger and more inclusive framework for global economic governance. Given its universality and unquestioned legitimacy, the United Nations has a central role to play in multilateral cooperation and decision-making. In this regard, it is important that the G20 continues to strengthen, enhance and systematize its engagement with the UN.

C. Governance reform at the international financial institutions

67. The 2010 governance reforms of the IMF and the World Bank Group (WBG) are seen as important steps towards a more representative, responsive and accountable governance structure. The IMF reform foresees shifts in quota shares to emerging market and developing countries of over 6 per cent, along with greater representation for emerging market and developing countries on the IMF Executive Board. The WBG shareholding reviews increased the voting power of developing and transition countries in the IBRD by 4.59 per cent to 47.19 per cent.[47]

68. The ratification process of the 2010 IMF quota reform has advanced somewhat, with two of the three thresholds for the reforms to take effect having now been passed. As of 10 July 2013, 140 members representing around 76 per cent of total voting power had consented to ratify the changes to the IMF's Articles of Agreement, falling short of the 85 per cent needed. In addition, the Fund's Executive Board completed its review of the quota formula in January 2013, and has committed to continuing these discussions to arrive at a new quota formula as part of its work on the Fifteenth General Review of IMF Quotas, to be concluded by January 2014.

69. Complementary discussions at the G20 have made contributions to the process. The G20 Communiqué of April 2013 highlighted that completion of ongoing reforms of IMF governance is indispensable for enhancing its credibility, legitimacy and effectiveness, while the distribution of quotas based on the formula should better reflect the changing relative weights of IMF members in the world economy.

[47] World Bank, "World Bank Group voice reform: enhancing voice and participation of developing and transition countries in 2010 and beyond", staff background document for the Development Committee Meeting, 19 April 2010. Available from http://siteresources.worldbank.org/DEVCOMMINT/Documentation/22553921/DC2010-006(E)Voice.pdf

70. Another important part of IMF Governance reform were the changes adopted in the selection procedures of the Managing Director. The new procedure adopted for the 2011 selection allowed the selection of the current Managing Director to take place in a more transparent manner.[48] In an important change, IMF Governors – usually the Finance Minister or central bank governor of member countries – are now able to nominate candidates for the Managing Director, which had hitherto been restricted to members of the IMF's Executive Board.

VII. Sovereign debt restructuring

71. After a hiatus of over a decade, the ongoing debt crisis in the euro zone has once again highlighted gaps in the international financial architecture with regard to timely and effective solutions to problems of debt distress. Debates on sovereign debt restructuring have direct implications for financing sustainable development, as countries with unsustainable debt burdens spend a large proportion of public resources for debt servicing, which could otherwise be spent on development goals. In addition, uncertainty surrounding sovereign debt restructurings increases both country specific and systemic risks.

72. For the first time, debt overhangs in developed economies are more pronounced than in developing countries. Developing countries are currently running historically low public debt to GDP ratios, posing virtually no systemic risks. In 2012, public debt as a percent of GDP for developing countries as a whole was 45.9 per cent.[49] Many low-income countries in sub-Saharan Africa benefited from comprehensive debt relief programmes over the past two decades, including HIPC and MDRI. Nonetheless, sovereign debt challenges remain in some small states and low-income countries. The problem is most acute among countries in the Caribbean, which were negatively impacted by the financial crisis due to strong links with the United States and Europe, a high dependence on tourism, and the erosion of trade preferences. In response to the slowdown in growth, several countries ran fiscal deficits and increased borrowing. As a result, since 2013, Belize, Grenada, Jamaica and St. Kitts and Nevis all sought to restructure portions of their debt.

73. In contrast, public debt as a percent of GDP in OECD countries jumped from around 70 per cent in the 1990s to almost 110 per cent in 2012. The increase in debt levels has been accompanied by downgrades of credit ratings in some countries, which for years carried AAA ratings. In particular, debt problems in Europe have once again highlighted the interlinkages between sovereign debt problems and the financial sector. Given the size of sovereign debt generally held by the banking system, sovereign debt crises can trigger bank runs and/or banking crises, potentially leading to regional or global contagion. Similarly, given the prevalence of 'too big to fail' institutions which can entail government

[48] IMF, "Managing Director (MD) Selection", 18 June 2012. Available at http://www.imf.org/external/np/exr/faq/mdselection.htm
[49] United Nations, MDG Gap Report, 2013.

bailouts, banking crises can trigger sovereign debt distress, with potential systemic implications due to regional and international holdings of debt. This has opened new sets of challenges in managing debt problems and international financial stability.

74. A central issue for domestic and international economic policy is how to reduce the occurrence of sovereign debt problems in both developing and developed countries. First and foremost, responsible lending and borrowing to reduce the chance of debt distress is crucial. Governments need to make regular use of analytical tools to assess alternative borrowing strategies, better manage their assets and liabilities, and restrain from irresponsible borrowing. At the same time, lenders need to better assess credit risk, improve credit screening and reduce irresponsible lending to high-risk countries.

75. Nonetheless, debt distress does occur, and can be costly. When debt burdens become excessive, there is a need for an effective mechanism that minimizes economic and social costs and allows countries to restructure their obligations in an effective and fair manner, and which also gives countries a clean slate to be able to resume growth and investment. For countries with market access, the current system has relied on voluntary approaches to writing down debt, such as the inclusion of collective action clauses (CACs) in bond issues, which are intended to resolve some of the creditor coordination issues in debt restructuring. However, CACs are only incorporated in bond issues, and thus do not address issues of priority across all creditors, including commercial banks and other non-bonded lending. Furthermore, there are aggregation problems when more than one series of bond issues are involved in the restructuring. The benefit of CACs in creditor coordination is further limited as holdout creditors still have the ability to take blocking positions in individual bond issues.[50]

76. For low-income countries, HIPC and MDRI, while important initiatives, accounted for debt relief as development assistance, which sidestepped the broader issues of how to address issues of debt overhang in a comprehensive manner. The international community has agreed to certain broad principles for debt restructuring, including “fair burden sharing” between debtors and creditors, as per the Monterrey Consensus (A/CONF.198/11, chapter 1, resolution 1, annex, para. 51), and “legal predictability”, as per the Doha Declaration (A/CONF.212/L.1/rev.1, para. 60). However, these have yet to be institutionalized in concrete practices.

77. The lack of an international bankruptcy procedure for sovereign debt restructuring has implications for the cost and speed of resolution of debt problems. Historically, it has been shown that this delay in restructuring can be extremely costly.[51] Lack of “legal predictability” creates uncertainties for both debtors and creditors, and raises important issues of equity. Recently, the issue of holdout creditors has elicited international concern,

[50] International Monetary Fund, April 2013, “Sovereign debt restructuring – recent developments and implications for the Fund’s legal and policy framework”.
[51] Herman, Barry, Ocampo JA, and Spiegel S, 2010, “Dealing Better with Developing Country Debt”, Oxford University Press.

with litigation against Argentina having the potential to increase the leverage of holdout creditors, thereby undermining the sovereign debt restructuring process.

78. The international community should more actively pursue the development of an agreed rules-based approach to sovereign debt workouts to increase predictability and the timely restructuring of debt when required, with fair burden sharing, including potentially providing a “safe harbour” for social protection floor outlays in the budget. Such an approach would reduce risk in the global financial system and free up resources for investment in sustainable development.

VIII. Conclusions

79. **Estimated financing needs for sustainable development while large, still represent a relatively small portion of global savings. The challenge lies in promoting a stable financial system that channels investments toward sustainable global development.**

80. **Foreign exchange reserves have grown over the past few decades, fuelled to an extent by the desire for ‘self-insurance’ against global systemic risks. Accumulation of foreign exchange reserves represents a form of constrained savings, which could be otherwise deployed for development purposes, while also exacerbating global imbalances and risks. Policies to address these issues could include increased SDR issuance, reducing global risks, and strengthening the global safety net.**

81. **Private capital flows to developing countries remain volatile and short-term oriented. Increasing attention is therefore being given to capital account management. In addition, efforts should be made in the source countries. Better international coordination of monetary policies and better management of global liquidity is needed. Consideration should also be given to incentivizing longer-term investments by bankers and institutional investors.**

82. **To effectively facilitate investments in sustainable development, financial regulation needs to be viewed in a broader context than is currently the case. In addition to a focus on stability, more attention should be given to promoting access to finance and ensuring that the financial sector promotes stable long-term sustainable growth.**

83. **Global ODA has suffered a decline in real terms over the past two years and is expected to stagnate over the medium term. At the same time, South-South cooperation has expanded rapidly, though it should not be seen as a substitute for traditional aid. While the need for ODA as a tool for poverty alleviation has lost none of its urgency, given the size of financing needs, the role of official financing in leveraging private resources is becoming increasingly important.**

84. **Other important issues pertaining to enhancing international financial stability relate to strengthening IMF multilateral surveillance and the global financial safety net. In recent years, the IMF has taken a number of steps to strengthen its surveillance activities, including an increased focus on cross-border and cross-sectoral linkages. A key element**

would be closer cooperation between the IMF, national central banks and regional and sub-regional mechanisms.

85. **The 2010 governance reforms of the IMF and the World Bank Group are seen as important steps towards a more representative, responsive and accountable governance structure. However, according to many developing countries these measures fall short of the objective of achieving fully legitimate representation of all countries, including the least developed countries. Moreover, the challenge is now to implement the agreed reforms in a timely manner.**

86. **The ongoing debt crisis in the euro zone has highlighted gaps in the international financial architecture with regard to sovereign debt distress. Countries with unsustainable debt burdens spend a large proportion of public resources to debt servicing, which could otherwise be spent on development goals. Uncertainty surrounding sovereign debt restructurings increases both country-specific and systemic risks. The international community should more actively pursue the development of an agreed rules-based approach to sovereign debt workouts.**