

THE OPEC FUND
FOR INTERNATIONAL DEVELOPMENT

Financing for Development

Proceedings of a Workshop of the **G-24**
held at Nigeria House, New York

September 6-7, 2001

The OPEC Fund Pamphlet Series

The OPEC Fund Pamphlet Series was begun in 1977, a year after the establishment of the Fund. The series is meant to promote a better understanding of the aspirations and problems of developing countries, including OPEC member states.

The OPEC Fund was founded as a multilateral development finance institution by the member states of OPEC to promote South-South solidarity and strengthen cooperation between countries of the developing world.

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Introduction

This issue of the OPEC Fund Pamphlet Series contains seven papers presented at the two-day *Workshop on Financing for Development*, held by the Intergovernmental Group of Twenty-four (G-24)¹ in New York, USA, on September 6-7, 2001. The workshop brought together some 70 officials from developing countries, their representatives at the United Nations in New York and the Bretton Woods Institutions (BWI) in Washington, and experts on different aspects of development and finance. The aim of the workshop was to provide the participants with an analysis of the issues and to discuss what strategies and options developing countries might consider as they approached the final stages of preparation for the International Conference on Financing for Development, which was scheduled to take place in Monterrey, Mexico, in March, 2002.

The workshop papers, which were prepared with a grant from the OPEC Fund, focus on four main areas: increasing the volume and effectiveness of foreign resource flows (private, bilateral and multilateral); establishing a more satisfactory representative procedure and an institutional framework for resolving external debt problems; making global economic governance more participatory and accountable to a broader community of nations; and creating an international trading environment supportive of growth and development.

The first paper discusses official development assistance (ODA) with respect to current trends, its role and importance in fulfilling the

1 The Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24) was established in 1971. Its main objective is to concert the position of the developing countries on monetary and development finance issues. Member countries are as follows:

Africa: Algeria, Côte d'Ivoire, Egypt, Ethiopia, Gabon, Ghana, Nigeria, South Africa and the Democratic Republic of the Congo.

Latin America and the Caribbean: Argentina, Brazil, Colombia, Guatemala, Mexico, Peru, Trinidad and Tobago, and Venezuela.

Asia: India, the I.R. Iran, Lebanon, Pakistan, Philippines, Sri Lanka and the Syrian Arab Republic.

development needs of the least developed countries (LDCs), and possible new sources for it in the future.

The second paper deals with issues related to private capital flows to developing countries, reviewing the development impact of these flows, the driving forces and the associated caveats and limitations. It also analyzes the role of multilateral development banks as financial intermediaries to aid private resource flows to developing countries.

In the third paper, the author examines three main issues: current debt settlement arrangements, notably the Paris and London clubs; various ideas on orderly debt work-outs, including standstill arrangements, “constructive defaults,” and mediation or arbitration schemes; and the feasibility of the FTAP (Fair and Transparent Arbitration Process) proposal.

A number of issues are considered in the paper entitled “Financial Crises and the Private Sector: Reducing Moral Hazard.” Topics covered include the problems of “socializing” private debt and moral hazard; the role of standards, codes, and regulations in avoiding financial crises; and the issue of the “lender of last resort.”

The fifth paper examines the current division of labor between the BWI and the UN system, and analyses the conditions and opportunities for an enhanced role for the United Nations in global economic governance.

In the sixth paper, a review is made of the current governance and decision-making structure at the World Bank and IMF, in terms of the allocation of voting power, the role of the executive directors, staff structures and recruitment policies, and the appointment of managing directors. The paper suggests a number of reforms to redress the balance in favor of the developing countries.

The final paper deals with several issues related to trade, commodity prices, and the role of the World Trade Organization (WTO). The paper argues that trade liberalization in many developing countries has been accompanied by higher trade deficits, de-industrialization, rising debt and financial instability. The detrimental effects of trade liberalization, it claims, have been compounded by the protracted deterioration in primary commodity prices, resulting in a call to reactivate commodity price agreements among producers in developing countries.

Foreword of the Director-General

For the second consecutive year, the OPEC Fund takes great pleasure in financing and facilitating the publication of the proceedings of a G-24 Workshop, the most recent of which was held in New York, USA, during the period of 6-7 September 2001. The first set of G-24 proceedings was made available in this Pamphlet Series in August 2001 under the title *Coherence or Dissonance in the International Institutional Framework: A Shifting Paradigm*. These workshops are an integral part of the Research Program of the Intergovernmental Group of 24. They aim at enhancing the understanding of policy-makers in developing countries of issues related to the international monetary and financial system, and at raising awareness outside developing countries about the special development considerations that should be taken into account during discussions on international financial and institutional reform.

The September 2001 workshop was held preparatory to the March 2002 UN Conference on Financing for Development, at which important decisions on a range of topics of special interest to the developing countries were expected. The papers in this volume discuss a selection of these topics, which fall under four themes: increasing foreign resource flows (private, bilateral and multilateral); establishing a satisfactory representative procedure and institutional framework for resolving external debt problems; making global economic governance more participatory and accountable to a broader community of nations; and, creating an international trading environment supportive of growth and development.

The establishment of the OPEC Fund for International Development by OPEC member countries dates back more than a quarter of a century to 1976 when OPEC held its First Summit in the Algerian capital Algiers. The Fund was conceived as an intergovernmental development finance institution, mandated to promote cooperation between OPEC member states

and other developing countries. The Fund pursues its objectives by channeling financial assistance to developing countries to further their social and economic development, and by facilitating their participation in international relations and global dialogue.

It is my belief that a fuller understanding of international monetary and financial conditions will assist the development effort and, ultimately, contribute to the development process. It is with this conviction that this brochure is presented to you.

Y. Seyyid Abdulai
Director-General
The OPEC Fund

Executive Summary

The papers included in this volume were presented at a workshop organized by the G-24 in preparation for the UN Conference on International Finance and Development in Monterrey, Mexico, in March 2002. The workshop papers cover four main themes:

- Increasing the volume and effectiveness of *resource transfers* in support of development. Under this issue, Official Development Assistance (ODA) and private capital flows are discussed separately, as each is driven by different considerations;
- Establishing a more satisfactory procedural and institutional framework for resolving *external debt* problems. This topic is approached from two different angles, i.e., methods to resolve the problem of sovereign external debt and dealing with moral hazard;
- Broadening and improving *global economic governance*. Two main issues are addressed: the role of the United Nations in economic matters, and accountability and transparency in the BWI; and
- Creating an environment for *international trade* that would be conducive to growth in developing countries.

By providing concessional funds to finance activities that are typically difficult to finance privately, ODA can play a valuable role in supporting the development process. However, without significant efforts by the international community and donor countries alike, the supply of ODA could face shortages in the coming years. Developing countries need to do their part by adopting sound macroeconomic policies and practices to encourage donors to continue offering ODA. These reforms, by improving the investment climate, could also help to attract private capital flows. However, it is also necessary to promote awareness in the industrial countries by explaining to the public why aid has not always worked, whether because of inappropriate policies or inadequate financing. Conditionalities have to be streamlined, taking into account the possibilities of policy mistakes and

insufficient support from the donors as well as other exogenous factors. For this purpose, an independent review mechanism needs to be established to elaborate on the mutual commitment of donors and recipients to prevent the failure of programs supported by ODA. Current proposals for new sources of ODA, such as the Tobin tax, the carbon tax or the tax on “Commons,” are still in the preliminary stages, and are mostly linked to specific uses, hence showing little promise for filling the gap for development finance needs.

Private capital flows provide an important avenue for escaping the poverty trap and catching up with the richer countries. Again, developing countries are urged to improve governance, control corruption, abide by the established codes and standards regarding banking, insurance and accounting, and grant foreign investors parity with their domestic counterparts. Foreign investors are urged to comply with the UN’s Global Compact, which is concerned with the principle of “good corporate citizenship,” covering human rights, labor standards and environment. The multilateral development banks could participate by providing partial risk guarantees in order to direct foreign direct investment (FDI) to developing countries.

Private capital flows are typically divided into foreign portfolio investment (FPI) and FDI, with both being intimately linked. Liberalizing FPI flows could encourage FDI by enabling foreign corporations to minimize their exposure risks and/or realize capital gains (from appreciated investments). However, the inherent volatility of FPI could leave developing countries with a dilemma. The abrupt opening of capital accounts can increase the risk of financial instability, while too slow liberalization could hamper the flow of FDI. Therefore, financial liberalization needs to be sequenced in a manner that would maximize the returns and minimize the risk of financial instability.

Multilateral development institutions could serve as catalysts to mobilize FDI in developing countries. One possible way is by designing both project-specific and generic schemes for risk sharing that would pave the way for private investors to go to developing countries. In addition, there is enormous scope for involving foreign investors in completing privatization programs. The performance of the World Bank Group as a catalyst could be improved by tackling the current “bureaucratic inertia” within the institution and introducing some changes in its Articles of Agreement. It is

also suggested that the World Bank should leave most conventional lending operations to the regional development banks and become an apex institution, with its functions confined to galvanizing private flows, promoting and financing privatization, and improving domestic financial systems in developing countries.

The resolution of external sovereign debt facing many developing countries today is closely linked to the issue of capital flows. The debt service burden in some of the poorest countries has become highly distressing, leading to poverty and declining living, health and nutrition standards. The goals of the HIPC Initiative, despite some counter claims, remain modest, and its conditions are too stringent. The debt overhang remains a serious problem for a large number of developing nations. Equally, existing debt indicators can be misleading, since they measure only what is actually paid and not the debtor's contractual obligations, and thus do not reflect arrears. This implies that, in the absence of a comprehensive debt workout, the debt problem will continue to worsen over time. As a part of improved crisis management and resolving the debt issue, it is suggested that efforts should also be focused on setting up a clear procedure for tackling sovereign bankruptcy. A good model on which these procedures could be based is the law governing the debt of municipalities and states in the United States, under Chapter 9 of Title 11.

Emerging market economies with open capital accounts are particularly susceptible to financial crises. Financial crises can lead to dire consequences at home and often spill outside the borders, hurting healthy economies. To limit the contagion effect and prevent default following a financial crisis in a country, it is in everybody's interest to restructure private and public debt as swiftly as possible. Individually, however, no private lender has the incentive or the means to provide the needed funds, even though, collectively, each country would benefit if every party played its part. In other words, emerging market financial crises present a global coordination problem, and justify the need for an international lender of last resort.

The International Monetary Fund (IMF), acting as a supranational lender of last resort, could solve the coordination problem, but in doing so it could simultaneously incur moral hazard and encourage excessive risk-taking, thereby inducing, rather than preventing, financial crises.

A number of proposals are suggested with regard to improving risk allocation, limiting the moral hazard arising from IMF lending, and spurring the private sector to tighten debt monitoring. These measures include making default painful, building trust, applying flexible rules to negotiations, supervising credit markets in both creditor and debtor countries effectively, improving information flows, conditioning IMF lending, keeping mediation mechanisms free from political pressures, and using collective action clauses and standstills.

Today, countries facing economic and financial crises have few alternatives and no policy options other than those prescribed by the BWI. This situation raises two interrelated concerns: (a) the need for outside, independent monitoring and evaluation of the performance of the BWI and regional financial institutions; and (b) the need for greater voice and representation of the developing countries, as directly affected parties, in the formulation and design of economic policy.

The United Nations, which has been virtually excluded from global economic governance in recent years, could offer its services as a solution to both these issues. There are a number of recent developments that boost the role of the UN in global economic governance. These include the increased (post-Cold War) consensus on global economy dynamics, the rising concerns about globalization and the global democratic deficit, the enhanced demand for global public goods, the UN reform making it a more attractive cooperating partner (e.g., for WTO and the BWI), and the increased incentives for private sector engagement with the UN. To capitalize on such opportunities, a number of conditions for a stronger UN presence in the global economy must be taken seriously: respect and reflect on the political laws of gravity in the global domain; comparative advantage in light of relations between governing structure and operative functions of the UN; and the urgent need to continue UN reform efforts.

BWI governance has become a focus of attention in recent years due to the increased importance and influence of the institutions in the conduct of economic and social policies in developing countries. It is, therefore, inevitable that the performance of the BWI would come to be evaluated by the standards of governance they hold important for developing countries. The key areas of concern relate to the significant tilt in voting power in the two institutions towards the industrial countries. This is in

contrast to many other international organizations under the UN umbrella where the rule of one nation, one vote applies, or, in other cases, where developing countries have much greater voting power. Acknowledging the possible difficulties in changing the constitutions of the two institutions, a number of ideas are proposed to improve the vote and voice of the developing countries in their governance. One possibility is to revise upward the “basic votes,” which have been left unchanged at their original levels (250 votes for each member regardless of the size of its quota), so as to restore the proportion of “basic” to total votes to the same level established at the inception of the IMF. Also in calculating the quotas for each country, the use of purchasing-power-parity (PPP) exchange rates, rather than actual (or market) exchange rates would help to shift the balance in favor of developing countries. In addition, the boards themselves could be restructured to have a better balance between industrial and developing countries and between large and small countries. Applying some of the established principles of corporate governance with respect to protecting the rights of minority shareholders could also be helpful. Additionally, there is a call for independent audit or accounting of the performance of the two institutions in terms of the quality and effectiveness of their diagnoses, prescriptions, and remedies.

Trade policy and the role of the WTO have been central to discussions of trade issues in recent years. Free trade is supposed to result in an efficient use of resources as countries exploit their comparative advantage. However, for many developing countries, the promised benefits have remained elusive. While imports have risen sharply, the expansion of exports has been constrained by problems of market access, on the one hand, and structural weaknesses, on the other. This has resulted in a general increase in trade deficits, requiring increased foreign financing. At the same time, the implementation of decisions reached during the Uruguay Round has been slow and selective. The industrial countries have backtracked on their commitments on liberalizing trade in agriculture and textiles, while developing countries, faced with the imperative of introducing new laws and regulations, have found it difficult to meet the complex requirements of TRIPs, TRIMs, and the new regimes for trade in services within the stipulated time periods. Although individual country positions differ, the developing countries’ agenda covers basically three points: (i) examining the

WTO mandate more carefully, confining it essentially to trade policy; (ii) recalibrating the WTO rules aimed at removing barriers to trade in order to promote development in developing economies; and (iii) carefully examining the new issues that the industrial countries are striving to bring into the WTO (labor standards, environment, and the issues mentioned above).

Report on the G-24 Workshop on Financing for Development

G-24 Liaison Office

Introduction

At the last meeting of the G-24, ministers emphasized the need for “full engagement of the G-24 in the preparatory process” for the UN International Conference on Financing for Development (FfD), to be held in Monterrey, Mexico, March 18-22, 2002. Towards this end, the G-24 Liaison Office¹ organized the Workshop on Financing for Development at the Nigeria House in New York on September 6-7, 2001. The chair country of the G-24, Nigeria, hosted the Workshop. A grant from the OPEC Fund for International Development financed the preparation of papers and of this report.

The principal goal of the workshop was to bring together high-level developing country officials from national capitals and their representatives at the United Nations in New York and the Bretton Woods Institutions (BWI) in Washington. The aim of the Workshop was to generate ideas on approaches and options that developing countries might consider in the context of the UN conference. This report summarizes the key issues that emerged during the two days of deliberations.

The workshop program and the list of participants are annexed to this report.

The Context

From the start of the preparatory process – some three years ago – there was a consensus among the UN membership on the need for a “holistic” approach in addressing the issue of finance for development, which required involvement of all key stakeholders in the process. Towards this end, an elaborate process of

¹ The Workshop was organized by Mr. William Larralde, Director, G-24 Liaison Office, Washington, DC. Preparation of this report and coordination of the papers presented was entrusted to Mr. Irfan ul Haque.

consultation between the governments and stakeholders was launched. Experts were invited to address the UN Second Committee (which is concerned with economic and financial issues), hearings were held for the non-governmental organizations (NGOs), formal and informal contacts were established with different official institutions, and the Internet was used to canvass the views of those that did not otherwise have access to the process in New York.

These initiatives notwithstanding, the process suffered from a number of weaknesses from the developing countries' perspective. For one thing, it proved to be a struggle to reach agreement on the agenda, format, venue and level of representation for the proposed event. This took up a good share of the time for preparation. It was indeed only early this year (2001) that the attention of the UN membership turned to substantive issues. Developing countries were also handicapped by the strained capacities of their Permanent Missions in New York to cope with the demands of the FfD process, while attending to all their other business at the UN. They do not have a secretariat or institution of their own (*à la* OECD for the industrial countries) that could provide them with the independent analysis and information they needed to negotiate their way through the UN procedures and meetings. An absence of close collaboration between the ministries of foreign affairs (which are in charge of the New York process) and finance ministries and central banks in the capitals, and between the country representatives at the UN and at the BWI was another handicap.

The G-24 Workshop was intended, in part, to remedy the last of the above-mentioned difficulties through the selection of topics for the commissioned papers, which aimed to address the second handicap: the absence of an independent analysis of FfD issues.

The Workshop's Scope

The provisional agenda for the UN conference contains six elements: domestic resource mobilization; mobilizing international resources (private capital flows) for development; trade; international financial cooperation for development (official development assistance); debt; and systemic issues. However, in designing the workshop program, a thematic approach was considered more suitable both for the discussions and for arriving at conclusions. The discussions in the PrepCom have ranged widely; however, four themes

of special interest to the developing countries could be identified where the UN conference could be expected to adopt important decisions:

- Finding ways to increase the volume and effectiveness of foreign resource flows (private, bilateral and multilateral) in support of development;
- Establishing a satisfactory, transparent and more representative procedure and institutional framework for resolving external debt problems;
- Making global economic governance more participatory and accountable to a broader community of nations; and
- Creating an international trading environment that is more supportive of growth and development in developing countries.

The program of the workshop was designed to address each of these themes in turn. Under “resource transfers,” a distinction was made between the issues involving official development assistance (ODA) and private capital flows, since they are driven by altogether different considerations. Similarly, external debt was approached from two different angles, i.e., methods to resolve the problem of sovereign external debt and to deal with moral hazard and the “socializing” of private debt. The third theme, global economic governance, covers a broad range of issues, but was narrowed to focus on the role of the United Nations in economic matters and the issue of accountability and transparency in the BWI. A separate session was devoted to discussions of trade issues.

In all, seven papers were commissioned. The papers were to provide the participants with a careful analysis of the issues, a critical review of existing proposals, ideas on how to deal with the issues, and suggestions on what strategies and options developing countries might consider as they approached the final stages in the preparation for the UN conference. The authors were requested to be forward-looking in their approach and to define the issues and options sharply, taking into account the recommendations contained in the Secretary-General’s Report and the Report of the High-level Panel under President Zedillo.

Report on the Discussions

In what follows, each of the workshop sessions is discussed separately.

(i) Resource Transfers: Official Capital Flows

Issues considered:

- The case for official development assistance (ODA).
- Financing of global public goods (GPG).
- The use of ODA to leverage private capital flows.
- Prospects for augmenting ODA and increasing its effectiveness.
- Innovative sources of financing.

ODA can be distinguished from other capital flows by the fact that it takes place at the discretion of the donors and is not driven by market considerations, even though it is often aimed at promoting market liberalization and privatization. Humanitarian considerations are obviously important, but ODA flows are inevitably driven by the donors' own development and political agenda. There is little question that the industrial countries have a stake in the growth of developing economies since, apart from offering expanding markets, rising incomes help to reduce social and political tensions. At the same time, some have linked the need for concessional flows to the process of globalization, which has generally failed to benefit the developing countries commensurately. The idea here is that as economies integrate into the global economy, the better-off regions should transfer resources to less well-off regions, similar to the income transfers within an economic union. More recently, the need for ODA has been linked to the need for financing global public goods (GPG), i.e., goods and services whose benefits are not confined to individual countries but extend to entire regions or to mankind generally. Examples of GPG are the protection of the environment, control of disease, and preservation of peace.

The overall magnitude of ODA in recent years has remained below 0.35% of industrial countries' GNP, i.e., less than half of the target of 0.7%. Although the political support for ODA in industrial countries other than the United States does not appear to have waned, a number of factors have contributed to a general disenchantment ("aid fatigue," as it has been called). These include budgetary constraints, disappointment with aid effectiveness, and the sheer enormity of the development challenge. At the

same time, a considerable portion of aid flows has been diverted to the servicing of past debt and coping with such humanitarian concerns as fighting hunger, malnutrition and disease. Important as all these areas are, they leave only a small amount for financing development as conventionally understood, i.e., investment in increasing a country's productive capacity.

Given these facts, the workshop focused attention on ways to augment public transfers and to improve their effectiveness. There was a general sense that in order to attract more resources, the developing countries must offer something in return. This search for a *quid pro quo* was described as a "grand bargain" or "development compact" that individual countries might make with the donors. Basically, this would involve, on the part of the individual aid recipient, adopting suitable policies in support of development (accepting and respecting conditionality) and improving their governance and human rights record in exchange for the donors carrying out jointly agreed programs and projects. (Concern was expressed about having a universal definition of the human rights to be covered.)

It was noted that such bargains or compacts would be between political unequals, but stress was placed on their execution being monitored by independent groups of experts, rather than by the BWI. In this connection, donor performance came under scrutiny. The donors' policy advice was not always sound or realistic in terms of implementation capacity, while the "transaction costs" of aid delivery tended to be high, most egregiously in the technical assistance area. It was proposed that the concept of "ownership" of policy reform should be broadened to include an independent evaluation of donor performance at the level of individual recipient country. This did not have to wait for a global agreement, since individual donors – or a "like-minded" group of them – could offer themselves for such an evaluation.

It was suggested that aid effectiveness could be improved by using official assistance to leverage private capital flows, especially in countries that are currently bypassed by foreign investors. Another suggestion was that individual industrial countries might accord domestic treatment to manufactures produced in developing countries by investors from those countries. However, it was pointed out that this might come into conflict with WTO provisions. Another idea related the use of tax incentives in home countries to investors investing in developing countries, but the experience of tax incentives given by host countries was not altogether encouraging.

However, ODA channeled into financing social and physical infrastructure was likely to be more promising, since the inadequacies in this sphere are usually a major deterrent to foreign investment.

Obtaining at least a rough notion of needs was seen as a precondition for finding the means for additional ODA, which in turn required a reasonably accurate picture of net resource flows to developing countries. For one thing, money for humanitarian assistance, meeting the millennium targets, financing GPG, and debt servicing, should be taken out of the estimates for development assistance. It was observed that the official data were often misleading, as they did not take adequate account of unrecorded, often illegal, outflows from developing countries. A sharp change in the terms of trade could also distort the picture on transfers of real resources.

In general, the prospects of bilateral ODA were not considered good, although donor performance could be expected to vary significantly across countries and over time. It is primarily because of this that there is a need to develop new sources of financing for development. Here, several ideas have been suggested. The best known, though also perhaps most controversial, is the so-called Tobin tax, which is basically a very small tax on short-term currency transactions across countries. Despite considerable doubts about its feasibility and effectiveness, the idea continues to be the center of attention in various world forums. Other innovative sources of financing include a “carbon tax” (which would be imposed on carbon emissions, and has been recommended by the Zedillo Report) and taxes on the exploitation of global commons, industrial country exports, or the sale of pharmaceuticals. The proceeds of the last one would be earmarked for the provision of expensive medicines and drugs at affordable prices in poor countries. This pharmaceutical tax has the advantage that it does not require a global agreement and could be adopted by individual industrial countries, perhaps even on a voluntary basis. However, such schemes present thorny issues of organization and implementation. Global taxes are probably the most appropriate means for financing GPG, but they must be separated clearly from ODA and debt relief operations.

(ii) Resource Transfers: Private Capital Flows

Issues considered:

- Developing countries’ policies and environment and FDI inflows: additional resources or simply a “race to the bottom”?

- FDI and development: why is FDI more supportive of economic development in some settings than in others?
- Portfolio investment and the issue of capital account liberalization.
- The role of multilateral development banks as financial intermediaries to aid private resource flows to developing countries.
- Private capital flows were seen as imperative if the developing countries are ever to emerge from the poverty trap and catch up with the richer countries since it is likely that there will never be enough concessional finance to support the investments needed for accelerated growth. If humanitarian assistance had been excluded, official flows for development would have amounted to barely US\$15 billion a year, compared to private flows of US\$150 billion, the average during the 1995-2000 period.

The central issue is how to attract private flows to the vast majority of developing countries that has so far been bypassed. Both the Secretary-General's Report (SGR) and the Zedillo Report (ZR) contain ideas, but lack specificity. Basically, the developing countries are urged to clean their house, improve governance, control corruption, abide by the established codes and standards regarding banking, insurance and accounting, and grant foreign investors the same treatment as domestic investors. Foreign investors are exhorted to comply with the UN's Global Compact, which is concerned with principles of "good corporate citizenship," covering human rights, labor standards, and environment. The multilateral development banks are urged to provide partial risk guarantees in order to direct FDI to developing countries.

The factors that drive foreign portfolio investment (FPI) are rather different from those for FDI, although there is a tendency to overplay the distinction between the two. FPI is seen as inherently volatile and unproductive (i.e., it does not finance new or "greenfield" investment) in contrast to much of FDI. However, in the more advanced developing countries at least, the two are intimately linked. Corporate treasurers concerned with minimizing corporate exposure risks and/or realizing capital gains (from appreciated investments) tend to seek exit strategies that have implications for host countries that are not much different from FPI (e.g., borrowing against fixed assets and quickly shifting capital abroad if warranted by deteriorating conditions in the host country). Thus, FDI tends to move to

countries that also attract FPI because their more developed capital markets permit such exit strategies to be implemented.

All the same, for the great majority of developing countries (especially the smaller economies), establishing domestic capital markets of sufficient depth might be impracticable in the short-run, and opening their capital accounts might prove premature until a proper prudential regulatory framework is in place. It was noted that there was a real dilemma. Opening capital accounts too quickly or abruptly could lead to an increased risk of financial instability; not doing it at all or too slowly, however, could provide cover to vested interests that resist needed reforms in the domestic financial sector.

That developing countries must have a congenial environment for foreign investment is axiomatic, but not very helpful advice, since many of the things that developing countries are expected to do are a result of development itself. The danger is that countries might compete for foreign investment by offering incentives, which would simply divert investment from one location to another. It was pointed out that at least in terms of labor and environment standards, there were indications that foreign investors' adherence to them tended, if anything, to be better than that of domestic investors. However, there was evidence of the "race to the bottom" in terms of offering fiscal or monetary incentives to foreign investors, with the result that the net benefit to the host country was considerably reduced. Where countries have relied heavily on foreign investment, dualistic economies have arisen. This is particularly the case among smaller, resource-based economies. At the same time, there are examples of countries (notably, Korea and Japan), which, as a matter of policy, pursued self-reliance and shunned FDI in the earlier stages of their development process.

Various ideas were considered for making the multilateral development banks – notably, the World Bank – serve as catalysts for mobilizing FDI in developing countries. The central problem is that private investors perceive the risks in developing countries as exceeding what they are willing to accept. What is needed is the design of both project-specific and generic schemes for risk-sharing that would pave the way for private investors to go to developing countries. In addition, there is enormous scope for involving foreign investors in completing privatization programs. It was noted, however, that the World Bank's offer of partial risk guarantees had failed to attract many investors. Similarly, the Multilateral Investment Guarantee Agency (MIGA) and the International Center

for the Settlement of Disputes (ICSID) had only limited impact in encouraging private capital flows. This failure could be partly attributed to “bureaucratic inertia,” but changes in the Articles would be required if the institutions are to play a more aggressive role in mobilizing private capital. It was also suggested that the World Bank should leave most conventional lending operations to the regional development banks and turn into an apex institution, with its functions confined to galvanizing private flows, promoting and financing privatization, and improving domestic financial systems in developing countries.

The special problems faced by the smaller developing countries were discussed. One view was that these countries were too small to have their own currencies or capital markets, and that they should seek to create regional arrangements for that purpose. It was, however, pointed out that capital markets are required to mobilize domestic savings for longer-gestation infrastructure projects and that dependence on FPI for such projects came up against the difficulty of finding hedging instruments of the requisite maturities at reasonable cost.

It was pointed out that while the encouragement of private flows is an important issue, there is also the question of how to make foreign investors take a longer-term view and support national development in poorer countries. Search for profit is certainly important, but often it is not an adequate basis for promoting economic development and equity. Two separate issues are involved here: the difference in private and social returns and factoring private investors’ risks in the cost of capital. Risk could, of course, be insured against through various instruments (including derivatives), but this could have prohibitive costs, even if the developing countries had the capabilities to devise and manage such instruments. The fact that any risk can theoretically be insured against does not mean that the insurance is affordable.

In order to ensure that foreign investment is supportive of national development, the question of corporate responsibility was raised. Private foreign investment could obviously contribute to economic growth by providing finance, physical capital, technology, and good business practices, but this is not always the case. Within the UN, a great deal of work was done on establishing a “code of conduct” for transnational corporations, but because of industrial country resistance, the effort yielded no result. It was suggested that this issue might be broached in the context of the FfD conference.

(iii) Sovereign External Debt

Issues considered:

- Current debt settlement arrangements, notably the Paris and London clubs.
- Review of various ideas on orderly debt work-outs: standstill arrangements, “constructive defaults,” and mediation or arbitration schemes.
- The feasibility of the FTAP (Fair and Transparent Arbitration Process) proposal.

The resolution of the problem of external sovereign debt, which many developing countries face, is closely linked to the issue of capital flows. The debt service burden in some of the poorest countries has become highly onerous and is causing economic retrogression, with declining health and nutrition standards. The HIPC Initiative is not inconsequential – as some critics believe – but its goals remain modest and conditions to qualify for it stringent. The debt overhang remains a serious problem for a large number of other developing countries, constraining their development efforts.

The existing debt indicators can be misleading because they measure only what is actually paid but not the debtor’s contractual obligations, and thus do not reflect arrears. What seems to happen is that the arrears on debt service continue to accumulate as “phantom” debt. This simply implies that, in the absence of a comprehensive debt work-out, the debt problem continues to worsen over time. The recognition of a situation of insolvency at an early stage is fundamental to minimizing the damage, since protracted negotiations year after year with unchanging cut-off dates – as happens under the current Paris/London Club arrangements – feed uncertainty and damage prospects for the economic recovery of the indebted countries. This situation benefits neither creditors nor debtors. Speedy resolution of the debt problem is not an act of generosity, but efficiency.

There are past examples when debtors were treated differently (notably, Germany during the post-war reconstruction period and Indonesia during the late 1960s, after the fall of President Sukarno) and given a chance for a “fresh start.” Learning from these experiences, what seems to be required is recognition of the rights of sovereign debtors and the introduction of a “fair and transparent procedure” (or FTAP), which involves applying industrial country bankruptcy rules.

The best model for dealing with sovereign bankruptcy is provided by the laws governing the debt of municipalities and states in the United

States, the so-called Chapter 9. The bankruptcy courts are founded on three basic principles of the rule of law, i.e., judgments are made by neutral and independent arbiters, creditors are not allowed to decide on their own claims, and the debtor's income earning capacity is not compromised. The Paris Club arrangements do not respect any of these principles.

A suggestion was made for making debt restructuring part of the development compact. The involvement of private sector creditors was seen as one problem, even if the principle of arbitration was accepted. There was also the question of what would come after arbitration: countries needed fresh money. Would it be available? Some developing countries were worried that this might turn off foreign private lenders.

However, all these problems were likely to be aggravated in a situation where external debt problems remained unresolved. There could be no new money without a "fresh start," and private creditors had not shown as much aversion to arbitration as feared. In any case, FTAP was not intended to bind every debtor country to those arrangements; rather each country should decide for itself how it wishes to deal with its problems. While these ideas might appear ambitious, past experience has demonstrated that ideas that appear unfeasible today, often become feasible later under changed circumstances.

(iv) Private Creditors and Moral Hazard

Issues considered:

- The problems of "socializing" private debt and moral hazard.
- The role of standards and codes as well as better regulation in avoiding financial crises.
- The issue of the "lender of last resort."

Emerging market economies, with open capital accounts, have proven to be susceptible to financial crises, which have dire consequences at home and abroad: they stunt domestic growth and tend to spill outside borders and hurt healthy economies. Domestically, financial instability can be managed through intervention by the central bank playing the role of a lender of last resort. When emerging market economies suffer financial crises, it is in the interest of all to contain contagion and prevent default, and to restructure the private and public debt of the crisis-engulfed economies. But this creates a "collective action" problem: a situation where no individual lender or

national central bank has the incentive to make the needed loans, even though collectively every country would benefit if every party played its part.

At present, the IMF acts as a supranational lender of last resort and attempts to handle this global coordination problem. But its intervention gives rise to moral hazard: by promising to act as a lender of last resort, it may encourage excessive risk-taking and thereby induce, rather than prevent, financial crises. The obverse of this proposition is that the private sector must be held accountable for the risks it takes. The interest premium charged – i.e., the “spread” over U.S. Treasury paper – already includes an allowance for the risk of default; hence there is no justification for “bailing out” the lenders. The question then turns on whether risk is being properly priced and factored into the cost of lending.

A related issue is to what extent the concern with moral hazard should be allowed to determine the policy and conduct of the IMF. It was noted that the likelihood of being “bailed out” would not generally be sufficient to induce foreign investors to jump into risky ventures or for domestic enterprises to undertake them, especially in light of the losses experienced in the aftermath of the Asian, Russian and Latin American financial crises. A different concern was that, in playing the role of the lender of last resort, the IMF was being selective, in that, while the claim-holders on “systemically significant” economies were bailed out, other countries (e.g., Ecuador, Pakistan) had been left alone to work out settlements with private foreign lenders, with no assurance of new money.

The ways to “bail-in” the private sector have been discussed at length in recent years, but no clear consensus has emerged to date. It was suggested that the official sector needed to maintain a “constructive engagement” with the private sector while letting it do the necessary monitoring and supervision of credit markets. However, the validity of this proposition was questioned: the markets were not regarded as having done the monitoring well. Greater efforts to enhance the quality, timeliness and reliability of the flow of information to markets could be combined with the development of “insurance products” to cover credit risk and restructuring risk to produce better outcomes.

It was also pointed out that industrial country financial crises were managed quite differently from the way developing country crises were handled. In the first case, the immediate response tended to be to loosen

liquidity along with the relaxation of regulatory requirements (as, notably, happened in the case of the Long-Term Capital Management crisis in 1998), while in developing countries, the approach had been exactly the opposite, i.e., tightening up of liquidity with interest rates allowed to skyrocket. This approach, during the Asian crisis, caused serious and avoidable economic distress and resulted in massive insolvency in the private sector. It was noted that one reason for the asymmetry in approach was that strong economies with weak banks could more easily cope with financial crises than weak economies with weak banks. Nevertheless, the issue remains that a policy package that worsens the economic and financial situation by its very design could hardly be expected to contain the crisis and its spread to other countries.

The feasibility of “standstill” arrangements was discussed. These might be necessary to prevent a period of financial turmoil from turning into a full-blown crisis or to avoid outright default once the crisis had begun. They might serve to stop the creditors’ race to grab assets, which hurts not only the debtor but also the creditors as a group. Standstills, however, need to be accompanied by policies to fix the economic situation and mandatory (if temporary) controls on capital outflows. Not every country would find this option appealing, but it should be a permissible route to adopt within a rules-based framework.

(v) Global Economic Governance: Enhancing the Role of the UN

Issues considered:

- The current division of labor between the Bretton Woods Institutions (BWI) and the UN system.
- The practicality of bringing the discussion of international financial issues within the UN General Assembly or ECOSOC.

Over the past two decades, developing countries have frequently had to turn to multilateral financial institutions – notably, the IMF and the World Bank – for help in crisis situations, notwithstanding the disproportionate weight of major industrial countries in their voting and decision-making structures. Countries facing economic and financial collapse have few alternatives and no policy options other than those prescribed by these institutions. This experience has given rise to two interrelated concerns: (a) the need for outside, independent monitoring and evaluation of the

performance of the BWI and regional financial institutions; and (b) the need for greater voice and representation of the developing countries, as directly affected parties, in the formulation and design of economic policy.

The United Nations – with its one nation, one vote – could offer its services as a solution to both these issues. However, in recent years, it has been virtually excluded from global economic governance precisely because the possibility of the developing countries wielding greater influence is perceived as a threat to the international financial system. It was argued that the UN suffered from inefficiencies and had not been set up to carry out operational activities – an argument that lacks force considering the UN’s serious reform efforts and its peacekeeping and humanitarian operations in recent years.

But the situation has begun to change. The agreement to hold the FfD conference itself is a manifestation of that. The reasons are complex and intertwined, but three stand out. During the 1970s and early 1980s, when the developing world asked for a “new international economic order,” the UN was seen as hamstrung by ideological differences. However, with the end of the bipolar world of the Cold War period, an increased convergence of views on economic policy has emerged, even though the “Washington Consensus” continues to be questioned. A second factor that has attracted attention to the UN as a more responsive body has been the increasing popular protest against globalization, as evidenced during recent WTO and BWI meetings. The UN is also seen as the appropriate forum for addressing the increased concern over the provision of global public goods.

These conditions would favor a more comprehensive, assertive role for the UN. However, the “comparative advantage” of the UN remains in norm or agenda setting, rather than in operations. Some described the UN’s role as a sort of “parliament,” serving as the apex body to which all other international institutions and agencies were accountable. It was also pointed out that the FfD process itself was a good example of the UN involving all stakeholders and overcoming the sensitivities of the BWI and the WTO about their mandates. In order to carry out an expanded role, the UN, however, needed to improve its “self-image” and enhance its moral authority, which had been tarnished in recent years by the emphasis on managerial deficiencies that needed to be reformed.

There was little support at the workshop for the establishment of new institutions or structures in the context of the FfD conference. The proposals for a global economic summit or Economic Security Council in the Zedillo Report were not given much chance of being adopted. In any case, there remained serious questions on the specifications of such proposals. For example, what structure and membership would the proposed Economic Security Council have? Would some members have veto powers? Similarly, the proposal for an International Tax Organization was considered premature, since it raised complex issues of its links with the UN and other specialized agencies, including the BWI.

On the other hand, a greater role for the ECOSOC in global economic governance – as proposed by the Secretary General’s Report – could be more practical, though even here there was the sensitive issue of the size of its membership. However, the basic attraction of the ECOSOC was that it had a clear mandate, and a solution could be found to ensure satisfactory country representation. The ECOSOC would play a central role in economic matters and would aim to bring about greater coherence and consistency in global economic policy, while leaving BWI to work within their own charters. All the same, this would call for formal arrangements on the reporting and accountability of BWI to this forum. It was, however, pointed out that ECOSOC would remain handicapped, even if such arrangements were feasible, if the WTO remained outside the UN family. Surveillance/review of the functioning of other institutions within ECOSOC could be a sensitive matter, and would be resisted by the institutions themselves and by the industrial countries.

(vi) Global Economic Governance: Reforming the BWI

Issues considered:

- The current structure of accountability in BWI.
- The increased role of G-7 and the US and the rise of new forums (e.g., G-20).
- The issue of “voice” versus “vote.”
- Application of corporate governance principles to BWI.

BWI governance is a critical issue for global economic governance, and has become a subject of debate in recent years. This is at least partly due to the

increased importance and influence of these institutions in the conduct of economic policy in developing countries and the extension of their sphere of concerns to domestic political and government institutions. This has given rise to a general sense that the broadening of conditionality tends to reflect and serve the leading industrial countries' own agendas. It was, therefore, inevitable that the performance of the BWI would come to be evaluated by the same standards of governance they hold important for developing countries. There is a perceived need for independent audit or accounting of the performance of the two institutions in terms of the quality and effectiveness of their diagnosis, prescriptions, and remedies.

The key areas of concern, from the perspective of the developing countries, relate to the preponderant voting power of the industrial countries in the two institutions. This imbalance is in contrast to many other international organizations under the UN umbrella where the rule of one nation, one vote applies, or where – as in the case of the Global Environment Facility and regional development banks – the developing countries have much greater voting power. The formulas determining the vote (quotas in the IMF and shares in the Bank) have changed little since the institutions' inception and, over time, they have become less and less linked to the importance of a country in the world economy. Thus, some of the largest developing countries that are also among the world's ten largest economies (e.g., Brazil and Mexico) have less voting power than some of the relatively small industrial economies, such as the Netherlands, Belgium, or Switzerland.

The governance problems at the BWI are reflected in the non-transparent procedure of selecting the heads of the two institutions, the use of qualified majorities in certain key areas of policy in addition to weighted voting, and the peculiar position of the executive directors, who are at the same time part of the management and representatives of their constituencies in the two institutions. Thus, concerns have arisen over the representativeness, even legitimacy, of the existing structure of global economic governance. That these concerns are at least partially recognized is reflected in the rise of new country groupings – notably, the G-20 – where developing countries (those considered to be “systemically significant”) are better represented in discussions on global economic policy and the reform of the international financial system.

While recognizing the difficulties in making changes to the constitutions of the two institutions, several suggestions were made to improve the vote and voice of the developing countries in their governance. For one thing, the “basic votes,” which have been left unchanged at their original levels, (250 votes for each member regardless of the size of its quota) could be revised upwards to restore the proportion of “basic” to total votes to that established at the inception of the IMF. Using purchasing-power-parity (PPP) exchange rates, rather than actual (or market) exchange rates, to evaluate the size of the economies for the purpose of calculating quotas would also make a difference, since the former tended to be much higher for the developing countries. In addition, the boards themselves could be restructured to have a better balance between industrial and developing countries and between large and small countries. Applying some of the established principles of corporate governance with respect to protecting the rights of minority shareholders could also be helpful.

Questions were also raised regarding the quality of advice and the competence of staff to handle financial crises. Here opinions differed in the workshop. Some felt that the competence of the staff in handling complex financial and economic issues was questionable; others felt that the weaknesses lay mainly in adapting policies and recommendations to different country situations. It was also pointed out that the BWI were responsive to criticism and were making efforts to become even more responsive, although progress was slow. Some argued that there was a case for a country to demand compensation when “grave negligence” on the part of an institution could be established. This would require independent assessment of the institutions’ performance.

The failure of developing countries to fully use their own power and influence in the international institutions was noted. It was pointed out that developing countries had not always wielded greater influence in the regional development banks where they had half or more than half of the voting power. Giving “voice to the voiceless” required more than seeking more votes.

There was agreement that greater transparency in the governance of the BWI could only help the institutions’ credibility and effectiveness without raising the cost of their operations. The IMF must continue to play its

role in averting and managing financial crisis; the existence of moral hazard is not a reason for weakening its lender-of-last-resort functions. Bilateral creditors cannot be relied upon, for they demand fulfillment of conditions of special interest to them, which became evident during the handling of the East Asian crisis of 1997.

(vii) Trade

Issues considered:

- The trade-development link.
- Commodity price instability and terms of trade shocks.
- Asymmetric world trading rules.
- Trade liberalization and rising trade deficits; the need for additional external financing.
- The interests of the developing countries in the proposed “development round.”

Trade policy and the role of the WTO have been central to the discussion of trade issues in recent years. Developing countries have been told that free and open trading regimes result in efficient use of resources as countries exploit their comparative advantage. Thus, trade liberalization and opening up their economies have been key pillars of policy reform. However, the promised benefits have been elusive. While imports have risen sharply, expansion of exports has been constrained by problems of market access, on the one hand, and structural weaknesses of developing economies, on the other. This has resulted in a general increase in trade deficits, requiring increased foreign financing. At the same time, implementation of decisions reached during the Uruguay Round has been slow and selective. The industrial countries have backtracked on their commitments on liberalizing trade in agriculture and textiles, while developing countries, faced with the imperative of introducing new laws and regulations, have found it difficult to meet the complex requirements of TRIPs, TRIMs, and new regimes for trade in services within the stipulated time periods.

Now, the industrial countries (especially, the European Union) are proposing a new round of trade negotiations, which, in recognition of developing country reservations, would be called the “development round,”

to address issues of market access and implementation of past commitments. In return, the industrial countries would like to bring new issues of competition policy and rules governing foreign investment, government procurement, and, quite likely, labor and environment standards into the multilateral framework. Developing countries are skeptical about the new round and the trade-offs it implies. They do not believe that problems of implementation require new negotiations (which inevitably involve compromises) and are reluctant to allow further broadening of the WTO's mandate to include the proposed new subjects.

Although individual country positions differ, the developing countries' agenda covers basically three points: (i) the WTO's mandate needs to be examined carefully and confined essentially to trade policy; (ii) even in the WTO's main area of concern (removing barriers to trade), the rules need to be recalibrated to promote development in developing economies; and (iii) the new issues that the industrial countries are striving to bring into the WTO (labor standards, environment, and the issues mentioned above) should be addressed by the agencies already set up to address them.

At the same time, there are trade issues of direct concern to the developing countries that are not being addressed anywhere, notably, the deteriorating and unstable terms of trade, commodity trade, diversification, etc. If the industrial countries were serious about labor standards and not driven by domestic protectionist pressures, they would also focus on the plight of primary producers in the developing countries, who are experiencing dramatic fluctuations in income from year to year. Similarly, environmental concerns could be extended to assessing the consequences of the production of synthetic substitutes in the industrial countries, and not just pollution from industry in the developing world. It was also observed that the sequencing and pace of trade liberalization had not been given adequate attention in reform programs and that serious losses of public revenue from import duties had added to the macroeconomic imbalances. A point was also made that abrupt changes in the terms of trade affected not only producers but also developing country consumers; the hardship from the recent oil price increase was noted.

However, the really hard question posed at the workshop was what trade issues should developing countries press for at the FfD conference? What bargain could be struck with the industrial countries in that forum?

There was a general recognition that matters under discussion within WTO – i.e., the new round – should not be brought into the UN conference. On the other hand, the problem of financing the rising trade deficits and terms of trade effects had implications for resource transfers and should be addressed on that occasion. Although commodity agreements had faced many problems, there was a case for revisiting them. It was also noted that there were divergent pressures within industrial countries. Banks and other creditors would like to see developing country exports rise to keep them creditworthy, while labor unions see those exports as a threat to jobs. Perhaps, in pursuit of a “grand bargain,” developing countries could benefit from such divisions.

Reflections on the Outcome of the Workshop

It is impossible to do justice to the richness of the discussion during the two-day workshop in a brief report, and it is to be expected that the participants formed their own opinions and conclusions. It is, therefore, necessary to acknowledge that this section is in the nature of reflections on what appear to be key outcomes of the workshop, rather than one of providing firm recommendations to be pursued in the forthcoming sessions of the PrepCom. These reflections are based on the views and impressions expressed by three experts on finance and development during the workshop’s concluding session.

In each of the four areas of concern – resource transfers, external debt, global economic governance, and trade – the workshop helped to delineate common ground, if it did not arrive at a convergence of views. With respect to resource transfers, developing economies will obviously require substantial foreign capital inflows (official as well as private) if they are ever to catch up with the richer economies. These transfers are needed to augment countries’ productive assets – in human as well as physical capital. Humanitarian assistance, curbing civil strife, or re-financing debt are certainly critically important in arresting the decline of living standards in a large number of developing countries. But clearly this is not enough: conditions for economic growth must be re-created.

Private capital flows rose sharply during the 1990s and now amount to a multiple of ODA, but the problem remains that they are not attracted to sectors where returns are slow to materialize (most infrastructure sectors)

or where the returns are hard to appropriate (education and health), or into countries where risks are deemed to be high. There is also some doubt whether private flows actually respond to needs, rather than flowing to countries in a herd-like fashion, as is evident from their very heavy concentration in only a handful of developing countries.

Various ideas were offered on guarantees and other instruments to insure against risk. The World Bank and other regional development banks could play a more active role in this domain, although going beyond what they are already doing would call for a change in their charters – by no means a simple task. Industrial countries could also do more to encourage capital flows to developing countries, but all the suggested means were considered to be either not particularly effective (e.g., tax incentives) or to be inconsistent with WTO rules. Clearly, the search for other methods to encourage private foreign investment must continue.

In the end, the conditions in developing countries will be decisive. Improving governance, reducing corruption, maintaining macroeconomic stability, and introducing effective banking supervision and regulation are all very worthy goals that must be pursued by developing countries in any case. However, the problem is that they are both the precondition and the consequence of economic growth. How can countries that are caught in the poverty trap be helped to break into the virtuous circle of growth-savings-investment? It is in this context that the role of official resource flows should be seen: if the industrial countries are to meaningfully contribute to development, they must greatly improve upon their recent record on ODA in support of development and investment. Provision of financing for development must be viewed as distinct from that required for meeting humanitarian challenges, supplying GPG, and refinancing past external debts.

But this gives rise to the second crucial question: What do developing countries have to offer in return? The participants wrestled with the notions of “a grand compact” and reciprocal responsibilities and obligations. Although the discussion lacked clarity, it was clear that the industrial countries would benefit directly from a developing world where standards of living were rising, permitting markets to expand and helping to curb social and political tensions, whose consequences – as recent events have demonstrated most tragically – can no longer be confined to isolated localities. It was recognized that globalization, far from “raising all boats,” has

caused much economic distress and has been a major factor in the widening of the income-gap between and within countries. Thus, as countries become integrated into a global economy and economic interdependence deepens, the case for income transfers from richer to poorer regions becomes hard to counter. This is certainly the practice within federations and economic unions; the examples of the United States and the European Union being particularly apposite. If this idea is accepted at the FfD conference even as a matter of principle, a significant step towards global harmony will have been taken.

There was general agreement at the workshop that emphasis had to be placed on enhancing both the quantity and the effectiveness of official transfers. Although it was difficult to be precise about the developing countries' needs, it was essential to reach a consensus on a rough order of magnitude. It was also felt that a clearer picture of the resource flows was necessary, taking account of terms of trade changes and unrecorded capital flows. Because of budgetary stringency and other priorities in the industrial countries, the need for exploring innovative sources of financing was obvious. Various suggestions were discussed in this connection, but none seemed to gain universal acceptance. It was pointed out, however, that there were steps individual industrial countries could take to raise financing for development without waiting for others to come on board; a specific example being a small tax on pharmaceuticals to subsidize the provision of medicines and drugs in developing countries.

The effectiveness of foreign assistance, on the other hand, required the recipients to gain greater control over the design of their development programs and independent monitoring of donor performance at the level of both the individual recipient countries and the recipients. Any reduction in the so-called "transaction costs" of foreign assistance implies a commensurate increase in resource flows. Again, this would not depend on all donors accepting the principle.

The issue of external debt is closely tied to resource transfers. As long as the problem of debt overhang persists, developing countries cannot have a "fresh start." What is needed is a system that is efficient as well as fair, which the current *ad hoc* arrangements of the Paris and London clubs clearly are not. The idea that ways should be found to apply the same principles on which domestic bankruptcy courts were founded to sovereign

debt received wide support at the workshop. Basically, this would involve devising arrangements that follow the rule of law in three respects: (i) an independent authority to preside over resolution of debt disputes; (ii) creditors must not be allowed to decide on their own claims; and (iii) every effort must be made to protect the debtors' capacity for maintaining essential social services and pursuing economic growth.

These ideas would obviously face strong resistance from both the industrial countries and international financial institutions, but they were issues that the developing countries could unite to pursue at the FfD conference. Even a simple recognition of the principle of "debtors' rights" would be a big improvement over the current state of affairs.

On the other hand, the workshop did not come to any clear conclusion on the actual handling of financial crises. The problem of moral hazard was discussed, and the need for involving the private sector and relying on market instruments was stressed. No specific suggestions were made, however, with regard to the need for an international lender of last resort or the IMF's role in general. Nevertheless, there was a convergence of views that any "solutions" that made economic and financial conditions worse – as experienced during the management of the Asian crisis – had to be avoided in future. And this conclusion is closely tied up with the issue of BWI governance.

The under-representation of the developing countries in the BWI is widely acknowledged. The workshop contributed a number of specific recommendations for improving that situation. These included raising the number of basic votes, applying purchasing-power-parity exchange rates to determine the relative economic size of the member countries, redistributing chairs within the executive boards in favor of developing countries and at the expense of European countries (which are over-represented), and incorporating the principles of corporate governance with respect to protecting minority shareholders' rights. A relative increase in the role of regional and sub-regional official development-oriented financial institutions might also help increase the voice of the developing countries in global economic governance.

Although these changes are likely to be vehemently resisted and probably dismissed as unrealistic, the developing countries must come together to pursue them. However, this effort will amount to little unless

developing countries also address the issue of their weak “voice” even in those institutions where they enjoy a larger vote. For this weakness, only they can be held responsible.

One of the central problems of global economic governance is the absence of an outside body to which the BWI are accountable. Here, too, the workshop participants agreed that the temptation to set up new institutions should be resisted and that the UN should play a more active role in economic matters. The UN reform was noted, but it was felt that staff cuts and other pressures had compromised the analytical capacity at the staff level. ECOSOC could serve as a sort of apex body with a mandate to discuss the coherence and consistency of economic policy, with the BWI invited to report on their activities and performance. This function, however, could not be satisfactorily discharged without enhancing the intellectual capital and standing of the UN staff. Because of the one-country, one-vote rule in the UN, quality work by the UN staff could be the key to giving the developing countries greater voice in global economic governance.

Finally, the workshop discussed a number of important ideas with regard to trade in the context of the FfD conference. There was consensus that care must be taken not to undermine the delicate negotiations that are going on in the WTO with respect to the proposed next round of trade negotiations. It was equally important that the WTO should come into the fold of the UN family of organizations. However, the problems developing countries are facing in international trade transcend trade policy and the WTO’s mandate. The missing “development dimension” is related to unstable and deteriorating terms of trade, heavy dependence on primary products, the need for diversification, and the judicious use of trade policy interventions in support of economic development. In the past, these concerns were addressed at UNCTAD, but now there is no institution to keep them under review. It was, therefore, necessary for the developing countries to speak with one voice on these issues at the FfD conference and to seek mechanisms to deal with these problems within the UN.

In formulating their demands, the participants were mindful of the need to offer something in return. The search for a global compact has been noted already. Here, in conclusion are three very worthwhile ideas, which were suggested at the workshop, that developing countries should consider as they define their negotiating positions: (i) developing coun-

tries should adopt and emphasize goals in their negotiations that the industrial countries also consider important (notably, human rights); (ii) the process should be cast in terms of a series of small bargains rather than one grand outcome; and (iii) the developing countries should build North-South alliances with NGOs on matters of common interest.

A final word: The FfD conference must be seen as the start of a process; an agenda for a follow-up is one of the outcomes the developing countries must seek.

On Official Development Assistance

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Abstract

Official development assistance (ODA) has two characteristics that make it the most attractive source of foreign financing for developing countries. First, ODA is provided to achieve certain goals that are not related to market returns, and second, it is concessional. ODA allows increased public investment in developing countries, without crowding out private investment, and promotes the development of the physical and social infrastructure that is needed to achieve social and economic development. Even for implementing market reforms, such public investment is necessary to carry out functions beyond providing public goods.

The provision of ODA from public money in the industrial countries depends less on the availability of funds than on how the public perceives the value of ODA. There is no real evidence of aid fatigue. However, there are reservations about the usefulness of aid and changing opinions about the role of foreign aid in a world of expanding private capital flows. Therefore, attempts should be made to use ODA to leverage increased flows of private capital by means of a program that would raise incentives for investing in developing countries. Such a program could give domestic treatment (in the industrial countries) to products manufactured in developing countries by firms financed by industrial country investors. Other motivations the program could offer include risk sharing, tax incentives and help to provide the infrastructure related to such investments.

Various proposals for additional sources of financing for development, such as the “Tobin tax,” the carbon tax, the tax on “Commons” and the “SDR link” are discussed in terms of their effectiveness for increasing ODA, rather than for financing global public goods that are not directly related to the development of poor countries. The available financing is not enough for that purpose. Creating appropriate motivation for ODA in the industrial countries is the crucial factor.

Assuming that promoting development is the objective of aid, it is important to explain to the public in industrial countries why aid has not always worked, whether this was due to the adoption of the wrong policies, or to inadequate financing. Conditionality has to be reviewed in terms of the possibilities for policy mistakes, insufficient support from donors, and other exogenous factors. Independent review mechanisms need to be established, and mutual commitments or reciprocal obligations must be worked out between donors and recipients that would prevent ODA-supported programs from failing.

The human rights approach to development provides a perspective of economic growth and social development with justice and equity. Human rights enjoy increasing support in industrial countries as standards for public policy and as norms for international relations. Pursuing development as a human right implies that nation states and the international community are ready to accept the obligation to cooperate on delivering this right to the peoples of the developing countries. In this case, ODA would become part of a development cooperation program designed to enable developing countries to follow appropriate policies and meet their requirements in full, if they implement those policies. A framework of “development compacts” is proposed in the pursuit of this approach, which, with the spread of the human rights movement, is gaining increasing support both in the world at large and in the industrial countries.

The Case for ODA

Official Development Assistance (ODA) has two main characteristics that distinguish it from the other flows of financial resources from industrial states to the developing countries. First, ODA is provided to the developing countries either indirectly through multilateral agencies, or directly by the official authorities of the industrial countries at their discretion. Such aid is motivated by their own interests or objectives, not by the desire for market returns. Second, ODA is provided on highly concessional terms. Almost 90% of ODA is extended either as grants, or as loans at low-interest rates with long maturity periods. Both of these characteristics make ODA particularly attractive for developing countries and preferable to other sources of external finance. Developing countries need foreign capital to supplement their own domestic savings and to raise the rate of domestic invest-

ment. Because of the two main characteristics of ODA mentioned above, ODA can supplement domestic savings in developing countries in a manner that other forms of external inflows cannot. Thus, ODA becomes a more effective means for bridging the savings gap and financing the rate of investment developing countries need in order to achieve a higher rate of growth.

The first characteristic of ODA allows it to be used to finance activities that market-based sources of funds would not accommodate. The discretion of the authorities in the donor countries providing ODA is based on their perceived interests. A substantial part of ODA during the Cold War era was related to political factors and security alliances. This fact helps explain the sharp drop in the ODA-GNP ratios of the major powers in the immediate post Cold War period, when these countries no longer needed their Cold War alliances. Even in that period, however, many donors were motivated by a genuine desire to promote development in the developing countries. They believed that closing the gap between rich and poor would not only serve their long-term commercial or economic “mutual interests” but also foster peace and prosperity in the world.¹ In allocating aid, they were usually guided not by what would yield the highest market return on their investments, but by what they thought would be the most effective means for promoting development.

ODA is one of the most effective methods for promoting development in low income countries because financial institutions there are weak, and physical infrastructure is under-developed. Moreover, since market prices often fail to give the right signals, and resources are immobile, market failures are endemic in low income countries. Even donors who believe that development is best promoted by properly functioning market forces agree that resource allocations at an early stage of development may have to be guided by indices of social gains, which cannot always be captured by market returns. What low income countries need most is investment in physical infrastructure, through substantial, if not total, public funding until these activities can be unbundled, and instruments can be developed to capture the limited gains spread throughout the economy. Investments in social development or human capital formation, education, health, housing, sanitation, water supply, slum clearance, rural development, food security and poverty reduction are needed even more. These investments constitute the basic

1 See the Pearson Commission Report, 1969: *Partners in Development*, Report of the Commission on International Development, Praeger, New York.

elements of any development program and are also essential for the stability and proper functioning of any market economy. Investments in these areas, however, must generally be financed from official aid sources since very little private funding is available from the market, and ODA is the only form of foreign capital that can finance such public expenditures.

The development experience of the past twenty years, when most countries moved from state-dominated planning and policy systems to more liberal market economies, shows clearly how the state continues to play a major role during the early stages of development, not only by regulating market forces, but also by promoting their proper functioning by means of increased public investment and expenditure. In certain areas, the public sector may still have to provide goods or services directly. In others, it may support and facilitate the private sector indirectly to provide such goods and services, through risk sharing, cost subsidies and various other incentives. The functions of the public sector that contribute to promoting private investment by developing physical and social infrastructure and ensuring social and political stability are different from government's generally accepted role of providing public goods. Even proponents of the "minimal state" would agree that only well-targeted public expenditures can prevent an under-supply of public goods. After all, public goods are *non-excludable*, i.e., one user cannot prevent another from using them, and *non-rival*, i.e., one person's consumption does not reduce another person's. Thus, profit-maximizing, isolated, individual market agents have little incentive to provide public goods. The public sector is in a position to do so because it can act at its own discretion and is not guided solely by market incentives.

Many of the activities that promote the development of physical and social infrastructure are not, strictly speaking, similar to providing public goods, since, in principle, schemes can be worked out that overcome the non-excludable and non-rival characteristics of these services, and financial instruments can be designed that can capture their returns as marketable assets. In the early stages of development, however, when capital markets are not well developed, and information flows and the movement of goods and services, and labor are restricted, these activities seem to possess most of the characteristics of public goods and to depend heavily on public expenditures. Private capital flows, which are guided by market incentives, seldom support these activities.

The problem with increasing public expenditures or investments is that these have to be financed by governments, either by raising taxes or by borrowing, both of which may have the effect of crowding out private investment, unless there is an additional flow of resources from foreign capital. When the government increases tax revenues, it directly reduces the amount of resources available to the private sector. Furthermore, government borrowing raises the interest rates with a given volume of domestic savings. To raise public expenditures without reducing private investment, government policy must aim at raising the amount of domestic savings, which in a developing country may be severely limited, or by increasing inflows of foreign investments. Since public expenditures are guided not by market incentives but by social objectives, increasing ODA is considered very important, not only by recipient countries, wanting to increase the public expenditures needed for accelerating development, but also by donor governments, which are then able to influence the deployment of public expenditures in recipient countries in a way that maximizes development.

Low-income developing countries are largely by-passed by private capital flows because they cannot attract private investment through projects with high rates of return, or reasonable risks, and must, therefore, depend heavily on ODA as a source of foreign capital. In our rapidly globalizing world, the overwhelming majority of the developing countries will not be able to increase their growth rates unless they receive ODA because their investment rates remain constrained by the lack of domestic savings. Despite the phenomenal growth of international private capital flows, private investors seeking high market returns will probably adopt a wait-and-see attitude in regard to the low income countries. Such investors are more likely to invest in the more advanced developing countries, which are capable of offering larger returns. In this case, ODA must play a major role in reducing disparities in the rates of development among the different developing countries.

This does not mean, of course, that private flows of international capital do not have much effect on the development of these countries. On the contrary, such private capital flows have many characteristics that may even exert a greater impact on development than ODA can, for example, by increasing productivity, or by promoting technology transfer and market development. This is true, even when ODA is used for technical assistance and for acquiring information and knowledge because many of the sources

of improved productivity come as parts of private investment. The main problem is that foreign private investors, guided by prospects of market returns, do not find operating in low-income countries sufficiently lucrative. If private flows could be attracted to these countries by special programs with risk-sharing or profit-augmenting measures, possibly supported by ODA, a net increase in available resources or foreign savings would occur in these countries. Even if private foreign capital flows cannot be used directly to finance public expenditures, they can help relax the constraints of domestic savings by supplementing these with foreign capital. Public expenditures can then be financed by governments without crowding out private investment, because a larger amount of capital is available.

In short, the major role of ODA is the financing of public expenditures and investments in developing countries. This is very important for those low income countries that are generally bypassed by private international capital. If the public sector of the developing countries could attract private capital from the international capital market, the burden on ODA for financing such public expenditures and investments would be lower. When private international capital does flow to the private sector in these countries, it supplements domestic savings and releases resources that are needed to finance public investments without crowding out private investment. Thus, another important role of ODA is to leverage the flow of private capital to these countries through special measures so that one dollar of ODA will generate several dollars in foreign capital flows to these countries. ODA can play all of these roles because it is given by donor country governments at their discretion and is not dependent on market incentives.

In addition, ODA has often been considered as a means for financing so-called *global public goods*, whose services benefit mankind in general, rather than any particular country, and are non-excludable and non-rival among different countries, similar to the national public goods discussed above. These global public goods include peacekeeping, the prevention of contagious diseases, research on medicines and vaccines, limitations on carbon dioxide emissions, the preservation of bio-diversity, and so on. Global public goods must be supplied through international collective action, since no one state has the ability or the incentive to produce or invest in these goods on its own. Supplying such goods and services will clearly

require international public expenditures, which ODA could well finance. It must be noted, however, that the aim of supplying such global public goods has little to do with helping promote development in the poor countries. If the primary aim of ODA is to finance national public expenditures that encourage development, taking ODA to finance global public goods is not the best use for this resource.

The second characteristic of ODA, i.e., its *concessional*ity, makes it particularly valuable for low-income countries since that allows them to use it for activities whose benefits are widely dispersed and cannot be captured to pay for its costs. ODA relieves low income countries of the need to borrow on international capital markets, and helps prevent them from becoming indebted and accumulating liabilities that have to be paid off within a certain period. The same reasons that prevent these countries from being able to tap into international private capital at a reasonable cost make concessional aid important for them. It is not that they cannot absorb foreign capital, or that their projects would not bring high returns, if efficiently carried out. It is only that the returns on most of the basic projects that can have a large impact on growth are mainly of a social nature and not reflected in private gains. Usually, at the early stage of institutional and financial development, these gains accrue in a manner that cannot be captured in a form that can be used for repayments. Concessional ODA allows developing countries to retain the surplus social returns generated by projects so financed, which thereby helps them raise their domestic savings and increase their rate of investment.

There is thus a very good reason why ODA should be extended only as grants and why the multilateral agencies providing assistance to low income countries should also give their assistance as grants. This is not the situation today, however, as about 10% of ODA, on the average, is still being given as loans, and the major items of multilateral assistance, such as IDA, are still provided as long-term loans, although at concessional rates.² Giving aid in the form of loans to low-income countries that do not have the capacity to make repayments, even when their projects yield high social returns, tends to push them into debt traps. This does not mean that aid should not be subjected to stringent scrutiny to ensure their efficient use and high social

2 The Zedillo Report, Section 4

returns. There should be no compromise on that. Nevertheless, efficiency in the use of these funds and a mechanism for mopping up their benefits in repayable financial flows are two separate issues. The argument for concessionality is based mainly on the inability of governments in low-income countries to work out such mechanisms at that stage of development.

As these countries develop, they will be able to build up the financial and institutional mechanisms for capturing the gains from such investments, or they will be able to mobilize increasing revenues through fiscal measures. They will then be able to meet repayment obligations fully, and the element of concessionality can be reduced parallel to improvements in their stage of development. At some point, these developing countries will be able to attract private capital from the international markets on normal terms. But until then, they will need concessional assistance provided by ODA and multilateral development agencies.

Concessionality is usually described in terms of the cost of ODA to the developing countries.³ But even if ODA is given as a grant – as a free gift – to the developing countries, it still has a cost to the donor countries. ODA flows cannot be sustained unless they generate returns that the donors perceive as being of greater value than the cost. Therefore, any program to increase ODA must be built on how aid resources are used and whether the donors see the effects produced as worth the sacrifice. Since ODA is public money from the donor countries, its costs should be figured in terms of opportunity costs, or what benefits that money could generate if it were invested in alternative avenues of public expenditure. These benefits must be evaluated on the basis of the donor countries' preferences or objectives. The donors may genuinely want to help developing countries achieve a higher growth of *per capita* income, or a visible reduction in their poverty, or they may want them to become a potential expanding market for their products.

³ The authors of the Zedillo Report and many others writers have talked about another element of cost related to aid-tying, the practice of forcing recipients to engage in high cost transactions, or to buy materials from expensive sources connected to donor countries. This, in effect, reduces the value of the aid, but not its cost, if it has been given as grant. If the alternative to aid-tying is the total withdrawal of aid, the developing countries would prefer to go on receiving it, no matter what the grant element is. In actual practice, aid-tying is motivated by the necessity for donor governments to "sell" foreign aid to their domestic constituencies in the name of promoting business at home. Tied aid, however, reduces the volume of effective aid to the developing countries. If this aid is given as loans, the recipient countries should not be asked to repay with interest the amount of aid that was reduced by aid-tying.

To achieve these goals they may be willing to sacrifice the alternative domestic use of these funds. Any program for increasing ODA, however, must also take into account the nature of the activities ODA will finance, in regard to efficiency, usefulness and avoidance of waste, and the effects they will have on the donors' foreign aid policy objectives.

These objectives change. What they were in the Cold War days need not be the same in this age of globalization and international cooperation. Even if donors are genuinely interested in the development of the poor countries, whether because of "mutual interest" or an accepted obligation to help them develop, as mentioned above, the donor's understanding of the development imperatives might change, thereby calling for different priorities and relative weights on the policies and outcomes of the use of aid. These issues must be carefully considered in any discussion of international development assistance.

The Prospects for Augmenting ODA

There is a prevalent belief that the industrial countries are experiencing so-called "aid fatigue," i.e., a growing reluctance to transfer resources to developing countries. The statistics of net ODA from the DAC countries to developing countries and multilateral organizations, do not, however, support this belief. ODA, as a percentage of the GNP of the DAC countries, has never reached 0.7%, the target that was set earlier at a UN conference, without much formal backing. Instead, ODA has hovered at around 0.33%, or slightly less than half the target amount, throughout the past few decades of development cooperation. For example, ODA as a percentage of the GNP of the DAC countries averaged 0.32% during 1975-76 and 0.33% in 1985-86. It was 0.33% in 1990, 1991 and 1992, but came down to 0.30% in 1993 and 1994. The decline in the later years, such as 1993 and 1994, was again due primarily to a substantial decline of ODA as a percentage of GNP in the United States. The ODA from the US was as high as 0.26% in the mid-1970s, and 0.24% in the mid-1980s, but fell to 0.20% in 1991-92, and has dropped steadily since then, landing at 0.10% to 0.11% in the late 1990s. Except for the United States, the ODA records for most of the DAC members show a significant increase even in constant dollar terms, as can be seen from Table 1 and figures 1 and 2.

Table 1:

**Volume of Net ODA by Individual DAC Countries at 1998 Prices
and Exchange Rates (US\$ million)**

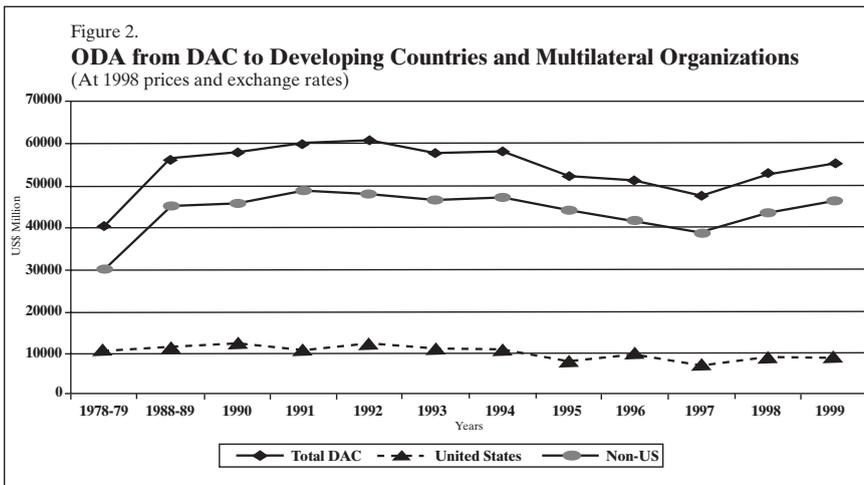
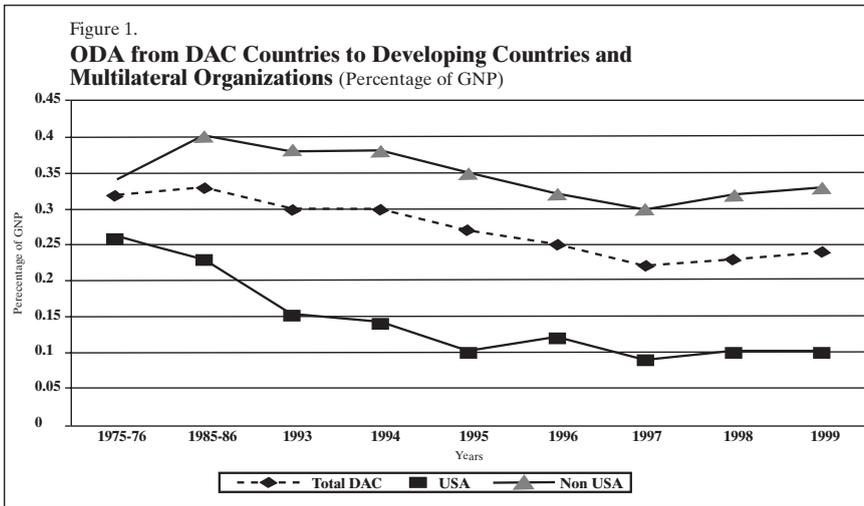
	1978-79	1988-89	1990	1991	1992	1993
Australia	911	1,033	861	926	934	938
Austria	298	383	439	598	528	557
Belgium	947	862	977	908	833	833
Canada	1,740	2,233	2,165	2,183	2,195	2,203
Denmark	803	1,221	1276	1,315	1,400	1,427
Finland	141	662	709	810	617	424
France	3,862	7,099	7,309	7,904	8,036	8,138
Germany	5,332	6,366	7,076	7,621	6,904	7,041
Greece*	- *	- *	- *	- *	- *	- *
Ireland	62	68	64	82	73	93
Italy	803	4,111	3,295	3,126	3,657	3,314
Japan	5,395	9,853	10,388	11,360	10,686	9,439
Luxembourg		24	28	45	38	53
Netherlands	2,043	2,695	2,721	2,711	2,716	2,592
New Zealand	117	100	97	104	107	105
Norway	643	1,028	1,139	1,125	1,128	1,047
Portugal	- **	158	190	247	298	259
Spain	- **	481	928	1,155	1,281	1,310
Sweden	1,461	1,831	1,839	1,845	2,034	1,909
Switzerland	394	765	829	929	1,171	834
United Kingdom	4,495	3,680	3,184	3,639	3,483	3,671
United States	10,689	11,263	12,163	10,830	12,156	11,111
Total DAC	40,136	55,937	57,678	59,465	60,274	57,297

Source: OECD Development Cooperation Annual Report 2000, tables 6a and 8 at www.oecd.org.

	1994	1995	1996	1997	1998	1999
Australia	990	1051	876	898	960	946
Austria	641	647	487	523	456	545
Belgium	711	875	802	764	883	785
Canada	2,163	1,951	1,657	898	1,707	1,674
Denmark	1,486	1,444	1,592	647	1,704	1,759
Finland	310	333	369	379	396	432
France	8,385	7,392	6,592	6,288	5,742	5,862
Germany	6,610	6,313	6,628	5,838	5,581	5,704
Greece*	– *	– *	168	168	179	195
Ireland	121	154	175	186	199	249
Italy	2,920	1,685	2,257	1,274	2,278	1,862
Japan	10,183	10,327	7,892	8,678	10,640	13,451
Luxembourg	59	57	74	95	112	121
Netherlands	2,473	2,746	2,869	2,954	3,042	3,213
New Zealand	106	104	96	127	130	135
Norway	1,169	1,114	1,147	1,215	1,321	1,328
Portugal	325	237	200	253	259	281
Spain	1,327	1,218	1,109	1,237	1,376	1,385
Sweden	1,901	1,590	1,729	1,684	1,573	1,686
Switzerland	941	887	875	913	898	999
United Kingdom	3,883	3,680	3,600	3,577	3,864	3,399
United States	10,673	7,752	9,680	6,964	8,786	9,010
Total DAC	57,375	51,558	50,876	47,561	52,084	55,021

* Figures not available.

** Figures for 1978-79 not available.



These figures do not indicate that there was increased apathy towards foreign aid or ODA in the DAC countries between the mid-1970s and 1999, except in the United States. There was not much enthusiasm for foreign aid in the DAC countries as a whole, but whatever enthusiasm there was does not seem to have declined during this period in any country except the US, and, to some extent, in Canada. Foreign aid in real terms, both as a total and *per capita*, continued to increase during those years, which shows that there was no significant opposition in these countries to sacrificing resources. Some of decrease in the nominal value of ODA after 1991 has to

be explained by factors other than aid fatigue, such as budgetary pressures, or disillusionment about the way aid had been used by some of the recipients. The ODA figures for the DAC countries, however, do not indicate a loss of interest or motivation for helping the developing countries, provided the recipient countries made proper use of the resources.⁴

Since 1997 the situation has improved, although the ODA performance of DAC as a whole has not increased, and the aid/GNP ratio for the two large donors, the USA and the UK, has continued to be below the levels of the early 1990s. The position of Japan, the world's largest donor, which fell from 0.32% of GNP in 1991 to 0.22% in 1997, recovered to 0.35% in 1999. Indeed, if the US figures are taken out of the DAC figures, the ratio of ODA to GNP of the remaining DAC countries, which had fallen steadily from 0.38% in 1993-94 to 0.30% in 1997, recovered in the next two years to reach 0.33% in 1999. More significantly, ODA in real terms, measured at 1998 prices and exchange rates, showed a sharp upturn after 1997 for the DAC countries as a group, whether with or without the US.

A recent World Bank study suggests that one of the reasons why all major donors reduced aid relative to their GNPs between 1991 and 1997 was that in recent years OECD countries had been struggling to control fiscal deficits and contain growth in government spending, and even though foreign aid was a tiny fraction of budgets, it had been one of the first items for the axe.⁵

There is some truth in that argument, although it does not explain the inter-country variations, or especially why the decline in the ODA/GNP ratio was greatest in the United States. US foreign aid was very much associated with the Cold War and the conduct of US foreign policy, and went mostly to countries with whom the United States had some kind of defense alliance or understanding. Perhaps support for foreign aid in the country and in Congress was dictated by the necessity for the United States to play the role of a major power in a world dominated by the balance of power. The other European OECD countries and Japan also viewed foreign aid as an instrument of foreign policy for expanding influence over other countries. However, this role of influencing others was

4 All these numbers are taken from the Statistical Annex of the OECD Reports on Development Cooperation, 1998 and 2000, Paris.

5 *Assessing aid: What works, what does not and why*, a World Bank Policy Research Report, 1998.

related more to historical relations between countries and to prospects for establishing future links, even after the Cold War ended.

Another plausible explanation is offered by the change in the whole paradigm of development cooperation that took place in the 1990s and is reflected in the composition of resource flows from the DAC to the developing countries. In the 1970s and 1980s, official finance, including foreign aid and other bilateral and multilateral finance, constituted about one half of all financial flows from the OECD to the developing countries. These funds were made available, mostly to government agencies in the developing countries, to finance and execute development projects, since private capital attracted by market profitability was not expected to be a major source of development finance. In the late 1970s, there was a surge in private flows that receded after the debt crises and fell below the level of foreign aid flows in the latter half of 1980s. But after 1991, private flows increased so sharply that by 1996, they amounted to almost four times the official flows. The development paradigm changed from one characterized by dependence on official flows for promoting development to one in which private capital responding to market forces began financing development. In most industrial countries, the donors lost their confidence in financing development through state agencies since they felt that policy changes and the quality of project implementation were often more important than the quantum of finance. Although many people in the industrial countries were willing to sacrifice and transfer real resources to the developing countries for their development, they were no longer willing to channel those funds through official agencies. That explains why, even without clear signs of aid fatigue, the level of foreign aid was reduced in relation to GNP.

A New Role for Foreign Aid: Increasing ODA to Raise the Net Inflow of External Resources

As we discussed in Section 1, a net inflow of external resources from any source whatever would supplement domestic savings and allow a general rise in the rate of investment, and, in particular, in financing for public investment and expenditures, without crowding out private investment. Thus, if ODA could be used to raise the inflow of external resources, it would indirectly help finance public investment and play a role in promoting development.

According to OECD calculations, there was an increase in private flows to the developing countries by nearly US\$90 billion in real terms from 1990 to 1995, although these flows were concentrated on only 10 to 12 countries. There is no reason why this trend should not continue in the future, unless there is a severe recession in the industrial countries. It might prove very beneficial to use foreign aid as an instrument for promoting a larger diversion of total financial capital from the DAC countries to those developing countries that have been bypassed by private capital flows and thus to correct the disparities in finance distribution.

In fact, if foreign aid can be used effectively to leverage private capital flows, it is possible that the quantum of foreign aid flows itself would improve significantly, especially in the United States. The governments of the industrial countries are often quite willing to use public money in their own countries to subsidize, promote and channel flows of private investment to desirable users. The governments of almost all industrial countries use their budgetary resources to provide tax incentives, capital subsidies and grants to stimulate private investment and direct it to areas that are considered backward or underdeveloped within their own countries. The same reasoning would apply to their using public money for promoting private investment in developing countries.

Indeed, several industrial countries have indicated their willingness to use official transfers of resources to augment private capital flows or to help resolve the problems capital markets have in maintaining financial flows to developing countries. Despite the general decline in foreign aid, the United States government has repeatedly shown its willingness to come to the aid of developing countries endangered by a financial crisis or a collapse of the capital market, with subsequent declines in output and employment. The latest examples of this were provided by the Mexican crisis, or the crisis in East Asia, when the United States came to the aid of these countries not only by providing a generous contribution itself, but also by mobilizing international capital through various multilateral agencies. Other countries have followed the example of the United States for reconstructing capital markets and promoting private flows, and have contributed generously to international financial rescue programs. It is true that these programs are usually confined to what are deemed “systemically significant countries.” Nevertheless, these cases show that when donors believe helping developing

countries with official finance corresponds to their own interests in preserving and promoting private capital flows, they show little reluctance to increase their aid. Thus, if a program could be worked out that used foreign aid specifically to promote private capital flows to developing countries, even to countries that are usually avoided by private investors, it is quite possible that even US foreign aid might increase in coming years to match similar increases from other industrial countries.

The first element of a program for promoting private capital flows to the developing countries would be to raise incentives for foreign investment with the help of ODA funds from the countries where these flows originate. These incentives could include giving domestic treatment in industrial countries to products manufactured in developing countries by investors from those industrial countries. For tradable products, if output and input prices approximated international prices, and if the developing country's government imposed no barriers on the exportables, and if the domestic investor's government imposed no export or import tariffs or quantitative restrictions, the rates of return on investments in sectors receiving such treatment would be able to capture the comparative advantage of the developing country. Thus, if firms investing in developing countries could export products from their foreign operations to their home countries without any tariffs or quota restrictions, the situation for the investing firms would be tantamount to extending their production activities across the borders of their home countries into developing countries and selling their products in their home markets, or exporting them to third countries, depending on the relative profitability. If these firms produced in developing countries for their own domestic markets, their risks related to output prices would be reduced, since they can be expected to know conditions in their home markets quite well. Furthermore, they would be able to make optimal use of low-cost production locations in the developing countries. Even if the developing countries retained some duties on exports and tariffs on imports, the relative profitability of producing goods in developing countries and selling them in industrial countries under the conditions enjoyed by domestic products would often be quite high.

Within the existing rules of the WTO, it may not be possible for a foreign investor's home country to give preferential treatment to the products of his offshore operations, relative to other MFN producers. There are,

however, a number of ways such privileges could be provided without contravening WTO provisions. First, the industrial country concerned may extend “Lomé treatment” to all developing countries’ exports, thereby allowing them to enter that country’s markets duty and quota free, as long as certain standards concerning the rules of origin are followed. If the governments of the donor countries find it difficult to extend a universal Lomé treatment to the products of all developing countries, these privileges can be limited to only low-income countries, or only to least developed countries. However, it would be better to avoid introducing any product or sectoral limitations. After all, markets are usually better judges of the potential comparative advantages of different countries and of which products industrial country investors can specialize in most profitably in a particular country. Even if some sensitive products were barred from such domestic treatment, that would not detract from the general appeal of this policy.

A second option would be to revive the generalized system of preference (GSP) and extend it to specific products or industries linked to investments from the industrial countries, keeping the option of granting preferential market treatment for such products in the home countries of the investors. It may not be difficult to get a dispensation from the WTO for this facility in the same manner that a dispensation was secured for the GSP in the late 1960s.

A third alternative would be to negotiate bilateral agreements with different developing countries, in which the industrial country adopting this policy of preferential treatment would offer “Israeli” treatment to a particular developing country for an asymmetric free trade arrangement. Under such an agreement, the products originating from the chosen developing country would be given free access to the markets of the donor country in return for the developing country’s agreeing to abide by certain policies and eventually to give free trade treatment to the industrial country’s products after a specified number of years. It is possible to exclude certain overly sensitive products from these arrangements, although such arbitrary limitations only reduce the effectiveness of free trade arrangements. This arrangement might be a very effective method for enhancing the value of investments in the partner countries, while, at the same time, insuring that the developing country concerned makes firm commitments to appropriate policies.

It should, however, be recognized that granting free-trade or domestic treatment to the products from very poor under-developed countries in industrial country markets may not be sufficiently interesting to attract investments to these countries, although it would reduce risks in projecting rates of return and, possibly, policy changes in the host countries. The actual value of the returns, however, would depend on the productivity of capital, which, in turn, depends on the level of infrastructure development, availability of skilled labor and a host of other factors requiring complementary investments. Experience following the Lomé Convention suggests that despite many years of concessional access for member states' products to the industrial countries, the supplies of their exportables remained limited. Effective steps need to be taken to invest in those sectors in developing countries that can increase supplies of exportables so that developing countries can truly benefit from concessional access and similar treatment.

It is here that ODA can play a catalytic role. For many low-income developing countries, a principal factor in low returns on investments is the inefficient supply of infrastructure services, most of which are not tradable. If investments in tradable sectors are to be made cost effective, they must be preceded by investments to enhance the capacity of such infrastructure services, which would help ensure that these services can be supplied at a reasonable cost. It is now possible to have technology from many industrial countries that can unbundle infrastructure services into different sectoral activities, permitting competition in the production and delivery of these services, and many multinational companies now have the capacity to provide these services in a cost-effective manner. However, because these products are non-tradable, their prices are dependent on domestic market conditions and government policies, which are all subject to high risk and uncertainty. The investors' home governments may then use their ODA to help promote infrastructure development in these low income countries either by directly financing public investments or by cofinancing adjustment programs supported by multinational agencies. In addition, such ODA can finance capital subsidies from the recipient governments or the donors themselves to the investors in such infrastructure projects.

Such capital subsidies could help lower the costs of investments or raise the effective rates of return for private investors, who could then raise market credit for the projects. Capital subsidies might be a very useful way

to spend small amounts of public money to leverage substantial amounts of foreign direct investment to the developing countries. For a foreign direct investor, however, what may often be even more important than cost-sharing is the coordinated implementation of the project, together with the development of backward and forward linkage industries, and the cooperation of the host country. ODA can promote such plans in recipient countries in the form of “technology parks” or “special investment or trading zones,” with liberal policies or special facilities.

In many infrastructure projects nowadays, the multinational corporations and foreign investors ask for guarantees from host governments against contingencies resulting from policy changes. These guarantees, of course, are not meant to ensure a minimum rate of return or profit from the project. The investors are still responsible for making correct market projections, calculating expected rates of return, and deciding whether their investments will be viable. However, when part of the return is dependent upon government policies on honoring contracts regarding the pricing and the quantity of infrastructure products, the collection of user charges, or the delivery of complimentary services, it is certainly legitimate for foreign investors to ask for guarantees from host countries that insure against such non-commercial risks. It would help enhance the attractiveness of such investment projects if such guarantees by the host governments were backed up with matching guarantees from the donor governments, to be met, when invoked, with ODA.

Tax Incentives

There is now a considerable body of literature to suggest that the tax incentives on foreign investments offered by developing countries actually play a rather limited role. When host developing countries provide such tax incentives, provided they are not neutralized by taxes in the investors' home countries, the cost of capital for foreign investors may be reduced. However, in most surveys conducted among foreign investors about the factors that determined their decision to invest in developing countries, tax incentives in those countries were considered much less important than the provision of complimentary services and the stability of government policies. Nevertheless, developing countries continue to provide tax incentives for foreign investment, mainly because of the competition from other

developing countries. For the developing countries, these subsidies cause costs and losses in revenues that are often very large as a proportion of total revenues, while for multinational companies, such reductions in their total tax liabilities may be quite insignificant.

It is possible, however, to argue that tax incentives provided by the home countries, i.e., the countries of origin of foreign investment, could lead to a substantial increase in foreign investment to developing countries at relatively small cost to the home countries' revenues or public money. The scope for doing so by reducing the tax rates on corporate incomes, is, however, rather limited, but providing *investment allowances* from the taxable income of corporations could be an effective method for promoting investment in developing countries at a relatively low cost to the treasuries of the investors' countries. Such allowances for promoting investment in special areas have existed in various countries for quite a long time. There is also considerable literature in support of using investment allowances to promote new investment, in preference to a reduction of the corporate income tax rate. While investment allowances for domestic investment have lost much of their appeal in industrial countries, in developing countries, where market failure in the allocation of capital investment is still a major feature of their economies, such allowances can play a significant role, provided the areas of investment are chosen appropriately. If an industrial country were to decide to allow investment credits equal to a certain percentage of investment by resident corporations in developing countries (or perhaps in selected developing countries or selected areas) from the total taxable income of the corporations (and not just from the repatriated income of the subsidiaries operating in those developing countries), this would certainly provide a significant incentive for foreign investment in developing countries.

Additional Sources of Financing for ODA

In the previous section, we discussed how a portion of ODA can leverage a multiplied increase in the flow of external resources to the developing countries. There is also substantial literature about additional sources of finance for augmenting ODA. Before considering these issues here, it is important to note that having more revenues in a country's budget, through new and innovative sources of finance, does not necessarily mean that a government will increase

that country's ODA. Indeed, ODA increases only when a government thinks incremental ODA will serve its purposes or objectives better than other ways of using those revenues. In other words, it is the use of ODA and the value attached to it by a donor government that determines the volume of ODA, much more than the availability of additional sources of finance.

In fact, the fraction of an industrial country's GNP that is disbursed as ODA is generally so small that even if the increase in ODA is relatively large (compared to a base year), it would not take much of a program to raise the required revenues. The original target for ODA, which was set at 0.7% of GNP, was itself very modest in relation to the public expenditures of the industrial countries. Except for Luxembourg, the Netherlands and three countries in Scandinavia, however, most countries have fallen far short of meeting even that target, not because they did not have enough budgetary resources, but because for them ODA was far less important than other expenditures. In the face of any prospect of a rising deficit, the first item to be cut in their budgets was ODA. Even now, if the industrial countries would all raise their contributions to ODA to the level of 0.7% of GNP, total ODA flows would rise by about US\$100 billion, trebling the current level of ODA and probably meeting most of the ODA requirements of low-income countries.

Nevertheless, an examination of some of the issues raised in the various proposals for new ways of raising revenues may be important because the international community has now become conscious of the need for providing global public goods, referred to above, which will require funding by public authorities through collective action. Whereas an adequate supply of global public goods, is, of course, extremely important for the proper functioning of the world economy, it is not related to promoting the development of the poor countries. These new demands on public money may, however, displace existing demands for development assistance. New sources of revenues may at least be useful for meeting these new needs and adding flexibility to the industrial countries' budgets, thus enabling them to meet the requirements for ODA.

The most important of these proposals is the "Tobin tax," which would impose a small tax of 10 to 50 basis points on all transactions on foreign exchange markets. Based on current estimates of the turnover on foreign exchange markets, even a tax of 10 basis points would yield US\$400 billion a year. This is, of course, a huge amount of money, and, if schemes can be

worked out to prevent the diversion of transactions between different markets and derivatives, this tax would be a substantial source of additional revenues. These revenues, however, would accrue to the authorities, who would have to agree to use them only for financing increased development assistance, or for supplying global public goods, and not to use them for their own budgetary purposes, or for financing other public expenditures. Of course, it would also be possible to reach an international agreement on cooperation, but such an agreement would depend on the political will of all governments to use these funds for development.

The Tobin tax has been supported not only because it could yield large revenues for development assistance but also because it would help curb speculation and stabilize foreign exchange markets. The debate, however, is still not settled, and there are cogent reasons for arguing that a small currency transaction tax is unlikely to have any stabilizing influence. Nevertheless, for our purposes, this additional characteristic of the Tobin tax, if it is valid, is good news, even if it is not relevant here. From the point of view of those interested in raising ODA, support for the Tobin tax should depend on its ability to yield large revenues and on the possibility for concluding an international agreement on enforcing the tax and using its revenues for augmenting development assistance.

Most of the other proposals for global taxation should be considered in the same manner. Some of them, such as the proposed *tax on carbon emissions*, or a tax on using “*global commons*,” such as the high seas, Antarctica or outer space, have implications for supplying global public goods, and their proceeds could be used for financing and regulating those supplies. Some, such as the carbon tax, also have a potential for yielding large revenues, part of which could be used for augmenting ODA, in addition to the management of global public goods. If an international agreement could be reached on using the proceeds of taxes such as the Tobin tax or the carbon tax for development purposes, that would imply that the international community had agreed to cooperate on raising resources for development and on sharing the burden. If that happened, there is no reason why such an agreement could not be extended to other, simpler, more straightforward methods, such as a small tax on the exports of all industrial countries, or on air travel, or on arms exports. If all countries agreed to impose a small, uniform tax on such transactions, that would have the least

distortionary effect, although it would yield substantial revenues. Even a mere 1% export tax on the exports of all industrial countries, would yield more than US\$50 billion a year, and would not divert supplies among the industrial countries, even if the tax were passed on to the importers and gave exports from developing countries a slight competitive edge.

The “*SDR link*” proposal, which is related to the creation of SDRs by the IMF and linked to augmenting resources for development assistance, is somewhat different. This is an old proposal that has been revived periodically; technically, however, it is quite feasible. Actually, the IMF has created SDRs several times as a means for expanding its resource base without having much effect on world inflation, although that argument is usually invoked against creating such additional international liquidity. The IMF no longer considers it necessary to create SDRs to fund its own operations: it regards its quota resources and ability to tap emergency resources through schemes such as the GAB or the NAB as sufficient for its purposes. SDRs, however, can still be created to satisfy the reserve needs of the member countries. The industrial countries have many alternative sources for satisfying these needs without recourse to additional SDRs, but the developing countries continue to have reserve needs that could be satisfied by the creation of SDRs. Although the use of SDRs carries some interest costs, while ODA usually does not, for the developing countries the possibility to draw on SDRs would be similar to having access to additional ODA, compared with the other alternatives available to them.

The main problem of the SDR-link proposals would be to convince the industrial countries to create SDRs they do not need themselves so that the developing countries could add to their reserves. When used, these reserves would claim resources as under foreign aid, while the industrial countries would have to hold additional SDRs as reserves. Indeed, there have been proposals for the industrial countries to give the developing countries these reserves as additional loans, which could be used again for further resource transfer.⁶ All of these proposals are technically feasible. Although the use of SDRs would not be like interest-free

⁶ See Arjun Sengupta, “The Allocation of Special Drawing Rights Linked to the Reserve Needs of Countries” in *International Monetary and Financial Issues for the Developing Countries*, UNCTAD, United Nations, New York, 1987, as well as *Finance and Development*, a quarterly publication of the IMF and World Bank, September 1986.

grants, it could be used by the authorities entirely at their discretion. These proposals, however, depend upon the industrial countries' willingness to accept the obligations of a resource transfer that is very similar to ODA, and that willingness, as mentioned above, will depend on how the value of such aid is perceived.

Towards More Effective ODA

This brings us to the fundamental question of the industrial countries' motivation for transferring resources under ODA. Why should the industrial countries give ODA and increase ODA levels? If we ignore military and security reasons, which seem to have lost their relevance in the post-Cold War years, the industrial countries' motivation for providing ODA must be related to their desire to promote economic growth in the developing countries, as we have discussed above. Their perceived benefit from that process of growth could be either political, i.e., a process they think will lead to a stable international political system, which they value, or it could be based on a notion of mutual benefit, which would also allow the industrial countries to prosper through expanding markets, increased trade and higher returns on their capital transactions. In addition, many people in the industrial countries genuinely want to promote overall development, to reduce poverty, deprivation, malnutrition, illiteracy and ill health, and to encourage technological, scientific and social progress in poor countries, just as they want similar goals for the backward regions in their own countries. The governments in these countries, which are all democratically elected, tend to follow policies that reflect the views of their constituents. Although lobbies and interest groups might influence specific policies for specific countries, the overall motivation for ODA is dependent on a general perception of the benefits of ODA.

Failures of Foreign Aid and Development Policy

Assuming that promoting economic growth in the developing countries has been the main motivation for ODA, there are still different views about the role and performance of ODA, according to one's views about how development takes place and what development policies are best. One question that is often asked today, after decades of using foreign aid

for development cooperation, is, “Why has foreign aid not been very successful in achieving its development goals?” Jeffrey Sachs has gone into some of these issues in a recent paper on Africa.⁷ According to Sachs, sub-Saharan Africa is a region that illustrates quite clearly how foreign aid has failed to achieve the most important objective it set for itself, namely, the growth of *per capita* income in that region. Despite several decades of continuous effort by the donor countries providing foreign aid and other kinds of external assistance, sub-Saharan Africa has failed to achieve either sustained or rapid economic growth; in fact, many countries in that region now have lower *per capita* incomes than in 1975. Sachs believes that instead of promoting growth-oriented policies, foreign aid has only increased the aid dependency of these countries. He therefore calls for stopping all open-ended foreign aid, especially to Africa, and suggests replacing it with assistance based on strict policy conditionalities designed to promote growth in those countries.

This reaction, however, begs the real question: Did foreign aid fail because it did not prescribe policy conditionalities, or did it fail because it promoted the wrong policies? Sachs admits that foreign aid to African countries, and, for that matter, to other developing countries, was always accompanied by substantial conditionalities. He criticizes especially the IMF and the World Bank for prescribing too many conditionalities, implying that they were unfocused, unnecessary and often unsupportive of growth-oriented policies. He suggests that such growth-oriented policies should have focused on market orientation, deregulation and trade liberalization as well as on fiscal discipline, but these were actually the basis of all the policy recommendations made by the donors and the multilateral agencies for the developing countries throughout those decades. During the past 10 to 12 years in particular, the African countries were universally brought under the discipline of the structural adjustment facilities of the IMF and the World Bank, and they all had to adopt these policies. The continuance of support by the international agencies was, in fact, made contingent on the countries’ fulfilling these conditionalities. In spite of – or because of – these conditionalities, the sub-Saharan countries consistently had less than 1% *per capita* growth of real GDP during those years.

⁷ Jeffrey Sachs, *A New Partnership for Growth for Africa*, Harvard Institute for International Development, Cambridge, Mass., 28 February 1997.

Economic policies are not just technical exercises. Their feasibility depends upon the political economy and their workability in a particular situation. If, as Sachs suggests, policy failures occurred in Africa and other developing countries, they did not occur for lack of knowledge or want of effort. They happened largely because the authorities in those countries could not cope with the economic and social costs those policies imposed, given the political constraints their countries were operating under. This is the only possible explanation for the way the IMF and the World Bank repeatedly accommodated countries that had failed to fulfill all the conditionalities of the programs. Although these structural adjustment programs went off-track again and again, the international agencies reformulated the performance criteria to help these countries come back with revised packages. It would be banal to label this “condoning the authorities’ mistakes.” It was rather a recognition that establishing economic policies belongs to “the art of the feasible,” and that funding agencies should help such countries correct their policies, rather than cut off their support.

During this process of repeatedly reformulating adjustment programs for the developing countries, the international agencies realized that adjustment policies based on liberalization and deregulation of markets and fiscal consolidation could not be sustained in these countries, unless their growth rates were raised and social safety nets were provided for the vulnerable groups. Growth promoting policies build on raising investment rates, which in turn, depend just as much on potential returns and the efficient functioning of the markets as on the policies and the stability of the system. Safety nets and expenditures on social development, such as education, health, nutrition, housing and sanitation, contribute not only to the stability of the system by improving the well-being of the population but also to increased productivity and enlarged capacity to absorb new technology. Many of the adjustment programs were thus redesigned to provide increased public expenditure for social development. One important reason for the lack of success of foreign aid can then be attributed to the faulty design of policies that focused primarily on market promotion and failed to emphasize the necessity for social development.

Inadequate flows of external resources were another major reason for the failure of the adjustment programs. Insufficiency in the volume of foreign aid shows up in three different ways: the savings gap, the import

gap and, quite often, the fiscal revenue gap. When considering the policy reforms of adjustment programs, international funding agencies usually make projections of the funding that is likely to be required to support the investment rate needed to maintain a particular growth rate, since this amount must be provided from outside sources over and above any projected increases in domestic savings. Furthermore, since policy reforms need time to bear fruit, and import requirements during the period of adjustment exceed exports and normal capital flows, the gap must be met by additional external flows, either from public or private sources. Any possible increases in government revenues as the result of tax reforms and rising incomes often fall short of minimal government expenditure requirements. Budgetary support from sources outside the government is often required if normal administrative and capital expenditures are to continue.

The requirements for external finance to meet these gaps are often quite large, and the largest of these various gaps becomes the binding constraint on carrying out the program. If external resources are not adequate to meet the binding gap, the program goes off track.⁸ Moreover, these gaps are only partially met by assistance from the multilateral agencies, in the hope that there will be other complimentary flows of external capital either from official bilateral donors or from direct investment. Time and again, these complimentary sources of external finance have not responded to the challenges of the situation and have failed to generate sufficient resources to bridge these gaps. As a result, most of these programs have remained under-funded even on the basis of the initial projections of required financing. If, in addition, some exogenous factor beyond a government's control occurs, such as natural disasters, crop failures, changes in the international prices of major import or export commodities, or sharp variations in interest rates on accumulated debt, the projected gap widens and the extent of under-funding often increases.

Policy reforms and flows of external capital are complimentary to each other, not substitutes for each other. External flows cannot achieve growth objectives without policy reforms, which, however, cannot be successfully implemented unless they are supported by adequate flows of external

⁸ Edmar Bacha, "A three-gap model of foreign transfer and the GDP growth rate in developing countries," *Journal of Development Economics* (32), 1990.

capital. The logic of this argument is applicable to all developing countries. For some states that already have reasonably well-developed infrastructure and a supply of skilled labor and financial services, policy reforms may be quick to fructify. In general, however, major bilateral or multilateral official initiatives will have to be taken to increase the flow of external capital. Policy reforms may eventually help to mobilize private capital flows, but at the early stages, external capital must come from official bilateral and multilateral assistance.

Conditionality

All of these arguments suggest that a review of the mechanism of conditionality is necessary. Discussions of conditionality have often been distracted by arguments about developing countries' sacrificing their sovereignty, or foreign agencies dictating policies, or how policies must be "owned" by the developing countries themselves. Superficially, there is no disagreement on these issues, and donor governments and agencies alike will always proclaim their support for the country ownership of policies since without it, no policy can succeed. The fact remains, however, that all development policies involve strict discipline and austerity on the part of the developing country governments, and the donors, who are granting the money, insist on that discipline. This situation would most probably remain unchanged even if policies were designed and owned by the developing countries themselves, and it is nonsense to think that donors would part with their money without making it conditional on certain policies being implemented. It is not possible to avoid conditionality in any such arrangement.

The point that should be considered, however, is the reciprocity of the obligations. No one is arguing that financial support should be granted with no conditions regarding policy reforms attached. However, as we have seen above, development programs fail not only because policymakers in developing countries make mistakes, but also because adequate financial support is not made available in a timely manner. Such mistakes occur because programs are poorly designed, or because the various policy elements are incorrectly sequenced, or are unable to respond to changing situations and exogenous variables, including political

exigencies. Conditionalities must have a built-in mechanism for the evaluation and arbitration of such matters before financial support can be stopped, or more stringent policy conditions imposed.

Most donor agencies do try to provide impartial reviews of these policies – usually by their management or their executive boards. However, in many cases, when under-funding or improper design is responsible for a program failure, the corrective action must be taken by the agencies themselves. To avoid any conflict of interests, the review mechanism in such cases should be independent of the agencies involved, even if it does not have binding arbitrary powers.

Both the IMF and the World Bank now have mechanisms to evaluate their programs. What is being suggested here is the creation of a different kind of institutional mechanism expressly for reviewing conditionality. The BWI should have a “Standing Committee of Independent Experts,” which could review the workings of the programs and any issues of conditionality and reciprocal obligations at the request of the concerned parties. The report of the Standing Committee would then be submitted to the relevant Executive Board, which would then decide on the Committee’s recommendations in consultation with the management. To be workable, the Committee’s function should not be that of arbitrating or bestowing awards. The Executive Board would retain the final authority on whether programs should be continued, terminated, or revised, and on financial support for them. The Committee’s function would be more in the nature of reconciling different points of view. The Committee would give concerned countries the feeling that their problems were being justly and fairly reviewed, and it would help the BW Institutions execute their programs more effectively by introducing mid-course corrections, if necessary. The Committee would aid the work of the executive boards, without, in any sense, overriding their authority.

Indeed, bilateral donors could also adopt a similar method for reviewing their activities in individual countries through “Standing Expert Committees,” attached to the ministries concerned, that would pass their reports on to the ministers for final decisions. In a democratic system, this would strengthen the position of the ministers and help make bilateral aid programs more transparent and accountable, and therefore more acceptable to the constituents, who, after all, ultimately decide on the extent of ODA extended.

The transparency and accountability of ODA-supported programs may turn out to be the most important determinant of continuing public support for ODA in the industrial countries. While the objectives of these programs must be formulated in a manner that allows a consensus to be developed, how programs are executed is often just as important for getting ODA from the public treasuries of the donor countries. The public needs to know that the finances it provides are used effectively and without any waste caused by corruption or faulty design, and that the programs financed serve all the people in the recipient country, not just specific interests. Now that ODA is no longer regarded as an instrument related to the donors' national security, the programs it supports must be seen not only as acceptable but also as highly welcome in the recipient countries. The donor countries would like to be recognized for their support in the countries they assist and be seen as acting not with ulterior motives, but with the desire to promote their development. An independent committee of experts reviewing and evaluating the conditionalities, the functioning of the programs and the use of ODA would not only help prevent the misuse of ODA funds, but also help the developing countries adopt the programs as their own.

A Human Rights Approach to Development

There seems to be a consensus that the objectives of ODA-supported programs should be related to the overall development of the poor countries. However, views about what development constitutes have changed significantly over the years. In the early years, the 1950s and 1960s, development meant the accelerated growth of *per capita* GDP. The development policies supported by ODA and international agencies were therefore oriented primarily towards rapid industrialization, increased agricultural productivity and higher rates of investment in well-coordinated programs. In fact, multi-lateral agencies and bilateral donors alike were not only promoting an active role for the state in development, but were also calling for comprehensive planning for development. Alleviating poverty, ending illiteracy, malnutrition and ill-health, and promoting social development and welfare were, of course, considered the ultimate goals of development policy, but rapid growth in GDP was regarded as the principal instrument for achieving these goals. Later, when it was realized that in many countries GDP growth alone

was not sufficient to achieve these goals, the donors began to encourage policies that would meet “minimum needs” and well-targeted programs for social development. At about the same time, the development paradigm began to change towards “human development,” with relatively less weight attached to programs designed only to stimulate GDP growth and raise the rate of physical investment. Gradually, there was also a shift away from emphasizing the role of the state to liberalizing markets and opening up economies to international competition. Since these strategies also failed to bring about visible improvements in the welfare of the people, these policies did not seem to work and lost support. Policy objectives then became increasingly concerned with improving governance, avoiding waste and corruption, and preventing the misuse of assistance.

Parallel to these changes in thinking about international development policies, the world has witnessed a significant expansion of the human rights movement. The governments of the industrial democracies accept international human rights laws as the standards and norms for international relations. During the Carter Administration, the United States brought human rights considerations into decisions on foreign aid policies and foreign economic relations for the first time. The European countries invoked both the promotion – and the violation – of human rights as influences not only on aid but also on trade relations with different countries.⁹ Initially, the violation of human rights, particularly civil and political rights, was used to withhold, diminish, or regulate external assistance and other economic relations. Eventually, with the gradual acceptance of economic, social and cultural rights as human rights, the promotion of these rights came to be regarded as policy objectives. In the industrial countries, the authorities concerned with ODA also found it expedient to plead for increasing the provision of foreign aid in the name of protecting and promoting human rights. In time, most of their aid programs explicitly incorporated the human rights approach to development. Even the multilateral development agencies, through the UNDAF process of the UN, the Comprehensive Development Framework of the World Bank, or through the Poverty Reduction Strategy of the IMF, supported by the Bank, built their programs on the different elements of that approach.

⁹ See for example, Tomasevski, Katarina, *Development Aid and Human Rights Revisited*, London Printer, 1993.

There were two main reasons for favoring the adoption of the human rights approach to foreign aid. First, many development objectives could be given concrete form in terms of economic and social rights. For example, there is a basic human right to food, health, education, housing, work and social security, as these are spelled out in the *Convention of Economic, Social and Cultural Rights*, a document that enjoyed wide support in most industrial countries. Secondly, in all international human rights agreements, the international community has accepted an obligation to cooperate with countries trying to fulfill these human rights. This obligation was openly accepted by all signatories to such agreements. Articles 55 and 56 of the *UN Charter*, which has the authority of an international treaty, also reflect this obligation by stating that all countries pledge themselves to cooperate in the achievement of these rights.

With the adoption of the *Declaration on the Right to Development* in 1986 at the United Nations, through various intergovernmental conferences and agreements, and culminating in the *Vienna Declaration* of 1993, the human rights approach to development gained almost universal acceptance in the industrial countries.¹⁰ There are three main characteristics of the human rights approach to development. First, the right to development is the right to a particular process of development in which all human rights and freedoms are to be realized. These human rights are related to all dimensions of human development, and are to be achieved in a manner that establishes not only entitlements to food, health, education, freedom from poverty, and equitable distribution of the fruits of development, but also culpability on the part of mankind for failure to achieve those entitlements.¹¹ Secondly, under the right to development, all rights to different aspects of human development are to be realized in an integrated manner. Since these rights are regarded as being interdependent, the programs to implement them must incorporate a development framework based on equity and justice. This, in turn, calls for the efficient use of resources that have been grown in a sustainable manner, which, in turn, depends on appropriate development policies and macroeconomic stability. Thirdly, although the pri-

10 See the three reports of the Independent Expert on the Right to Development, Arjun Sengupta, dated 27 July 1999 (Ref. No. E/CN.4/1999/WG.18/2), 17 August 2000 (Ref. No. A/55/306), and 2 January 2001 (Ref.No.E/CN.4/2001/WG.18/2). Website:<http://www.unhchr.ch/html/menu2/7/b/mdev.htm>.

11 For a discussion of the differences between the human development and the human rights approach to development, see *Human Development Report*, 2000, UNDP, Chapter 1.

mary responsibility for delivering the right to development to all individuals lies with the states of which they are citizens, the international community also has a responsibility or obligation to cooperate with the developing countries in delivering these rights.

These obligations to cooperate are implied quite unmistakably whenever a country accepts the human rights approach to development. While there were some reservations about the right to development when the international declaration on that right was first adopted in 1986, over the years international conferences and agreements have succeeded in removing those reservations. In 1993, a consensus was reached in Vienna at the *World Conference on Human Rights*, when all states agreed that the right to development is an inalienable human right and recognized the obligation to cooperate with concerned countries to help them realize that right.

This obligation to work together, of course, does not mean an obligation to increase foreign aid, but it does mean that the members of the international community must cooperate with each other to find effective means for helping countries that are endeavoring to achieve the right to development. The transfer of resources is only one such means for doing so. Others may be related to trade liberalization, debt reduction, codes of technology transfer and multinational behavior, financial architecture, or intellectual property rights. Any of these means can have a great impact on the developing countries' process of economic growth. For example, appropriate trade liberalization in the industrial countries alone may yield US\$140 billion in additional foreign exchange earnings for the developing countries. However, if these means cannot be used or do not produce sufficient results to help these countries achieve the right to development, the transfer of resources will remain an essential element of the industrial countries' obligation to cooperate with the developing countries.

These ideas have generally been accepted by the donor community, which has incorporated, in different forms, the commitment to help realize human rights in both their ODA programs and other forms of international economic relations. However, these notions have not always been formulated as reciprocal obligations, as the human rights approach to development implies. According to the *Vienna Declaration*, when a country is working to the best of its ability to achieve human rights for its citizenry, including the right to development, the international community is obligated to cooperate with that state and to help it deliver those rights.

In his 1999 report to the Human Rights Commission in Geneva, the Independent Expert on the Right to Development suggested the adoption of “development compacts” by the industrial and the developing countries, based on mutual commitments to fulfill conditions for implementing development programs. The idea of a compact was first launched by the Norwegian Foreign Minister Thorvald Stoltenberg in the late 1980s and was elaborated on by other development economists and various writers in the UNDP’s Human Development Reports.

It [*the compact*] was meant to support programs which the developing countries were supposed to implement according to a sequenced design of policies with a clear commitment by donors to provide the required assistance in terms both of finance and trade access and other policies, to match the efforts of the recipient countries.¹²

If these “development compacts” are formulated as a method for implementing the right to development, the mutual commitments are placed firmly in the context of human rights. The developing countries would accept the conditionality of designing and implementing, in a mutually agreed manner, an appropriate program for achieving a development process focused on the poverty eradication and human development needed to realize human rights. If they did so, the industrial countries would implement, as their part of the mutual obligation, a program for development cooperation covering several areas of trade, debt and finance, including additional flows of development assistance.

These ideas of reciprocal obligations have already found some support in international development discussions. At the *World Education Forum* in Dakar in 2000, a framework for action plans towards education for all was adopted when the developed countries agreed that if any country made serious efforts to achieve their education goals, it would be assured of receiving the external resources essentially required for that purpose. The Kanbur-Sandler proposal for common pools of assistance, to which the Zedillo Report refers, is also a variation of this approach. If a developing country presents an acceptable program for development, after mutual consultations with the donors, they would put an unrestricted amount of financing

¹² The first report of the Independent Expert on the Right to Development, to the Commission on Human Rights, Geneva, (E/CN.4/1999 WG. 18/2, 27 July 1999)

into a common pool for development assistance to prevent the program from failing. The recently declared “Compact for African Recovery,” which operationalizes the Millennium partnerships in Africa, is also firmly based on the notion of mutual commitment or reciprocal obligation.

Such a development compact will have three essential elements. First, the developing country must formulate a program. This will be done through consultations, conducted not only within the country with a maximum of transparency and fair participation of the citizenry, but also with other countries and donor institutions as equals. The program should indicate the policies and sequential measures that must be adopted to realize the right to development. At least some of the basic human rights, such as those to food, health, education, or freedom from want must be implemented, without violating any other human rights. These rights imply an entitlement to the availability of and access to related goods and services. For instance, satisfying the right to food involves not only increasing the amount of food available, but also improving the mode of access so that food is distributed equitably and without discrimination. Policies should spell out clearly what should be done, and, if they fail, who should take appropriate action, as the determination of culpability implies.

Secondly, the development compact should include the responsibilities of the other parties, such as the donors and multilateral agencies, and specify what steps they are to take in this cooperation, in addition to providing ODA. Since the right to development means that individual rights have to be realized within the context of a sustainable development program and their interdependence has to be taken into account, development cooperation must be aimed at satisfying the requirements for realizing the whole program, in terms of additional resources and other international policies. In other words, the ODA requirement should be assessed for achieving a country’s entire development program, and not just for realizing a particular right in isolation. For example, the right to health cannot be realized in a sustainable manner unless the right to food is also realized. Similarly, poverty eradication cannot be sustained unless the right to education is also fully realized.

The third element of the development compact would involve setting up a mechanism to monitor the implementation of the program. Such a mechanism would determine who is responsible if there is a deviation in

the program and how to redress the situation if any mistakes occur, or the program fails. This monitoring mechanism must be independent and fair so that the conditionalities associated with the program will be acceptable to all those concerned.

A Fund for Financing Development Compacts

The details of all the steps necessary for initiating human rights-based development may take a long time to receive international approval, but an *ad interim* plan can be formulated even without them by any developing country in which some of the basic ingredients of development meet the goals of justice and equity, the core principles of human rights. In the beginning, the developing countries may want to concentrate on poverty reduction, food security, primary health care and basic education in a manner that is transparent, participatory and equitable. The human rights conditionality would be fulfilled if no other rights are violated, including civil and political rights, and if no regression occurs in any other social variables, including unemployment and social security. For these rights to be protected, the country needs to have a reasonable, sustained rate of growth, realized in a manner that does not increase disparities or cause social conditions to deteriorate.

These are the minimum requirements of the rights approach to development. If developing countries accept the responsibility for implementing such a program of development, they can expect the international community to accept the obligation to cooperate with them and help them meet their requirements. The industrial countries should be able to raise the funds required for this purpose as additional ODA. They could raise money for this increase in public expenditure in the same way they do for meeting their domestic obligations to protect and promote the welfare of their own vulnerable populations. The human rights approach has two advantages: these rights are universally recognized, and the responsibility for fulfilling them is likewise universal.

If people in the industrial countries are properly motivated to help realize a rights-based approach to development, it is difficult to imagine that their governments would not be able to raise the necessary resources; after all, these would represent only a small increase in their public expenditures. For example, if an international fund in the amount of US\$50 billion

a year were created for financing these programs, the additional burden on the DAC countries would be only 0.20% of their GNP of 1999. The actual ODA to GNP ratio of these DAC countries was only 0.24% of GNP that year, and together with an additional 0.20%, the ratio would amount to 0.44%, far less than the 0.70% target for ODA that was set in the 1970s.

The Zedillo Report has estimated that the additional cost for achieving the 2015 international development goals set at the Millennium Summit would amount to US\$50 billion. A human rights-based approach to development could be designed without much difficulty around the 2015 international development goals. Some changes could be made in these goals to bring them into line with the human rights approach to development, which aims not only to provide increased goods, but also to ensure an access to them that respects human dignity. We could have several other targets as well, and not all of them would have to be accepted by all countries. For example, over and above the goals of halving poverty and hunger, we could also have the following objectives: achieving universal primary education; dramatically reducing infant and maternal mortality; eliminating HIV/AIDS; and guaranteeing adequate primary health care, housing, and sanitation. Any of these targets could be adopted by any developing country, if it agreed to and formulated a program for realizing them according to the human rights-based approach. The international community should then be in a position to commit itself to providing that country with the necessary financial support to reach those targets.

To achieve this, an international fund for financing such development compacts amounting to US\$50 billion a year should be set up. All that would be necessary would be to reach an agreement on how the burden sharing for that amount should be distributed among the industrial countries. In Table 2, we give two possible alternatives for such burden sharing. In the first alternative, each country's individual burden would be determined on the basis of the weight of its GNP as a proportion of the GNP of all DAC countries. In the second, the ODA/GNP ratios of all DAC countries would be raised to 0.44%, except for the five countries whose ODA/GNP ratios are already close to the original 0.7% target. These scenarios are based on 1998 figures, but figures from other years could also be used. The following table shows clearly how marginal the increase in the burden of each industrial country would be.

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Table 2:

ODA Burden Sharing: Two Alternative Scenarios

Country	ODA % of GNP 1998	ODA US\$ Mn. 1998	Weight~	Model 1 Burden Share# US\$ Mn. 1998	Target ODA/GNP** Percent	Model 2 Burden Share* US\$ Mn.
Australia	0.27	960	0.016	785	0.44	604
Austria	0.22	456	0.009	458	0.44	456
Belgium	0.35	883	0.011	557	0.44	227
Canada	0.30	1,707	0.025	1,256	0.44	797
Denmark	0.99	1,704	0.008	380	0.99	0
Finland	0.32	396	0.005	273	0.44	149
France	0.40	5,742	0.063	3,170	0.44	574
Germany	0.26	5,581	0.095	4,739	0.44	3,864
Greece	0.15	179	0.005	263	0.44	346
Ireland	0.30	199	0.003	146	0.44	93
Italy	0.20	2,278	0.050	2,515	0.44	2,734
Japan	0.28	10,640	0.168	8,390	0.44	6,080
Luxembourg	0.65	112	0.001	38	0.65	0
Netherlands	0.80	3,042	0.017	840	0.80	0
New Zealand	0.27	130	0.002	106	0.44	82
Norway	0.91	1,321	0.006	321	0.91	0
Portugal	0.24	259	0.005	238	0.44	216
Spain	0.24	1,376	0.025	1,266	0.44	1,147
Sweden	0.72	1,573	0.010	482	0.72	0
Switzerland	0.32	898	0.012	620	0.44	337
United Kingdom	0.27	3,864	0.063	3,160	0.44	2,433
United States	0.10	8,786	0.388	19,399	0.44	29,872
Total DAC	0.23	52,084	1.000	50,000		50,011

Notes:

~ Weight represents the ratio of GNP of individual countries to the sum of DAC GNP.

Burden Share represents the weight of each individual country multiplied by the target of US\$50,000 million.

** For Denmark, Luxembourg, the Netherlands, Norway and Sweden, the target ODA contribution has been taken as their actual ODA/GNP percentage contribution for the year 1998. For all other DAC countries, target ODA/GNP percentage has been estimated at 0.44% of GNP.

*Burden share has been calculated by subtracting the actual contribution in 1998 from the estimated contribution. The rates mentioned in the previous column have been used for arriving at the estimated contribution.

Sources:

1. OECD, Development Cooperation: Efforts and Policies of the Members of the Development Assistance Committee 1998 Report, (France: OECD, 1999). Statistical Annex A7-A8, Table 4.
2. OECD, Development Cooperation Annual Report 2000 at www.oecd.org.
3. UN Commission on Human Rights, "Study on the current state of progress in the implementation of the right to development," submitted by Mr. Arjun K. Sengupta, Independent Expert. E/CN.4/1999/WG.18/2 July 1999.

The second element in the proposal would be that these amounts should be kept in a separate international account, managed perhaps by the DAC Secretariat, to be used when needed. Any developing country with a properly worked out plan for realizing the targets described above that also agreed to follow the human rights approach and accepted the implied conditionalities would be eligible for financing from this fund. The fund's secretariat, or the DAC, would help in the formation of a "Support Group" for that program, with representatives from the World Bank, the IMF, the regional banks, the various UN agencies dealing with the subject (e.g., the FAO for food issues, the WHO for health, or UNICEF for primary education), and the Human Rights Commission. These representatives would examine the requirements for assistance and make sure that no other rights are violated and that the country has a reasonable rate of growth. They would take into consideration the supply of resources from other bilateral and multilateral sources, which should not be allowed to fall, and then determine what policies the industrial countries should follow to meet their obligations for cooperation.

Third, on the basis of this examination, the Support Group would call on the international development fund to release the needed resources, and each industrial country would provide the required assistance up to its maximum level of burden sharing.

Fourth, the Support Group would also be responsible for monitoring the programs and taking whatever steps might be necessary to make mid-course corrections. Moreover, since disagreements could occur among the parties, there should also be a provision for appointing an independent Group of Experts, who would be able to examine the issues and adjudicate disputes. The Support Group would retain, however, the final authority to accept or reject the recommendations made by the Group of Experts. In any case, the whole process should be open and transparent so that if any recommendations were unfair and arbitrary, the public in the democratic countries would be able to react swiftly.

Mobilizing Private Sources of Finance for Development

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Abstract

Private capital flows (PCF), in their various forms, have burgeoned in the 1990s, thereby diminishing the significance of official capital flows except for in the poorest, least developed countries. This paper examines the role of PCF in financing development, and looks at a number of related issues and problems. It considers whether foreign direct investment (FDI) has fuelled a race to the bottom in terms of adherence to labor and environmental standards, and concludes that the opposite has occurred, i.e., globalization has resulted in FDI's raising rather than lowering standards in developing countries, coupled with the unfortunate effect of creating dual labor markets. The paper also identifies domestic and external factors influencing foreign portfolio investment (FPI) and looks at its potential impact on developing economies given its volatility and how premature liberalization of capital accounts can vitiate the benefits of FPI while amplifying its risks. It concludes that there is much to be learned about FPI managing and regulating at source and destination, and about unconventional approaches to managing crises induced by FPI volatility. Finally, the paper examines what industrial and developing countries as well as international financial institutions (IFIs) and, in particular, the multilateral development banks (MDBs) can do to increase the flow of private capital and ensure its distribution to a larger number of developing countries and regions.

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The Significance of Private Capital Flows

Historically, cross-border private capital flows (PCF) have been the immutable in financing development investment. There were brief interregnums when this was not the case in 1950-70 (the Bretton Woods era) and 1983-89. By contrast, official capital flows (OCF) i.e., government-to-government financial transfers involving conditionalities, are a more recent, transient phenomenon in development financing. Their efficacy raises many doubts. Yet an implicit preference for OCF remains rooted in the development community. That preference was reinforced when PCF revived in the 1970s – when oil surpluses were recycled by the global banking system – only to result in the debt debacle of 1982 and to collapse again between 1983-89. Concomitantly, OCF increased through the 1980s, but they financed mainly debt service, not development. The Brady Initiative of 1989 reduced unsustainable debt obligations and paved the way for PCF to recover. The year 1990 marked a sharp turning point with PCF displacing OCF more abruptly than had been anticipated.

PCF surged between 1991-97 (Table 1), experienced a brief hiatus in 1998-99, recovered in 2000 and fell back again in 2001. Contrary to predictions, private flows have weathered the Tequila crisis (1994-95), the Asian crisis (1997-99), and subsequent financial crises (2000-2001) in a number of countries ranging from Argentina to Ecuador, Pakistan, Russia, Turkey, the Ukraine and Zimbabwe. At the same time, OCF have become less significant for the developing world, although they remain crucial for several developing countries, and this may be a permanent feature of future financing for development.¹ Ways need to be found, therefore, of get-

1 Official finance has become less important in relative and absolute terms. In the 1990s, ODA stagnated at US\$50-55 billion in nominal dollars, thus falling considerably in real terms throughout the decade. Only about US\$40 billion went to developing countries by way of financial flows. Less than 40% of that amount (i.e., US\$14 billion) financed development investments. The remainder was absorbed by administration and technical assistance (expenditures that are mainly in donor countries), humanitarian assistance, and food aid. ODA is unlikely to ever be as significant in financing investment as PCF, although it remains crucial for low-income countries, especially the HIPCs. It is unimportant for most middle-income countries (except for a few small island economies) and for industrialized low-income countries with market access. Still, a large proportion of ODA goes to countries that do not need it. Most of the ODA provided in the 1980s was used to finance external debt service to private creditors (mainly banks in the developed world) and was aimed at stabilization, not investment. For that reason, ODA in the 1980s came to be associated with increasing poverty and dispossession; a link that contributed to perceptions of aid failure.

ting PCF to more developing countries through various channels, i.e., foreign direct investment (FDI), bank lending and foreign portfolio investment (FPI) of equity and debt instruments through capital markets.

PCF play a key role in countries that have the capacity (i.e., physical and institutional infrastructure, markets, governance) and opportunities to absorb it productively. On a *per capita* (rather than per country) basis PCF are better distributed across the developing world than often appreciated (Table 2). While 70-90% of PCF go to 10-25 developing countries, these countries account for 60-75% of the developing world's population, 60-70% of its output, 65-80% of its trade, and 60-80% of its international reserves. Thus, to a large extent, the distribution of PCF reflects the distribution of the developing world's "market capacity" (Annex 1). Economic theory suggests that PCF to the developing world should be increased for the following reasons:

- Global gains are derived when capital flows from high-income (capital surplus) countries to low-income (capital deficient) countries where the productivity of investment is supposed to be higher. But the overall impact on global welfare may be moderated because many low-income countries, by their nature, are characterised by low productivity of investment. That can, however, be raised by the entry of FDI, which brings with it inputs of technology and improved labour productivity, and introduces better management of firms and resources.
- Unrestricted global PCF permit better risk reduction through portfolio diversification on a global scale. In practice, however, overall portfolio risk may actually increase when investment portfolios embrace emerging markets in their early stages of development, with risk reduction occurring only as such markets develop and mature.
- Global integration of capital markets leads to diffusion of best practices in public, as well as corporate governance and regulation; and
- Global capital mobility restrains governments from pursuing poor economic and financial policies. Again, however, experience suggests that this happens only when governments have been weaned from reliance on official sources of finance that prevent them from suffering the full consequences of erroneous policies.

As the qualifications made above suggest, the arguments in favour of foreign investment are not all one-sided. Foreign direct investment (FDI) in an

industry can deter investment by domestic firms in the same industry so that an increase in FDI may not result in increasing the overall level of gross or net domestic investment. PCF can increase imports and dampen domestic output and investment. Surges of foreign portfolio investment (FPI) in fragile financial systems can threaten stability and complicate macroeconomic management. With variable exchange rates complicating calculations of real returns, there is a tendency for FDI and FPI to be exchange and interest rate sensitive and to deploy risk management instruments and practices to protect value. Such practices can exacerbate, rather than ameliorate, financial crises.²

Annex 1 expands on the impact of PCF on development. Available empirical evidence indicates that: (a) PCF have had a positive impact on domestic investment but not necessarily on growth; (b) the impact of PCF depends on absorptive capacity – differences in such capacity explain why PCF have a greater impact in some countries than in others; (c) faster growth and higher investment have attracted more PCF to middle-income countries thus reinforcing a virtuous circular “high resource flow – high growth” dynamic that has eluded low-income countries; (d) the impact of PCF on domestic investment weakens as a country’s domestic financial system integrates with global capital markets, although PCF still have a positive impact on productivity; and (e) if PCF do not have a positive influence on increasing total factor productivity, they may not impel growth, even when they finance additional investment.

The Views of the Zedillo Report on Stimulating Private Capital Flows

The Zedillo Panel Report (ZPR), based on the Secretary-General’s Report (SGR), observes that

[p]rivate capital cannot be expected to finance poverty reduction or human development ... [but it] ... can be an important factor in promoting growth – or in precipitating crises. [Furthermore,]

² Persaud A. “Sending the Herd Off the Cliff Edge: The Disturbing Interaction Between Herding and Market Sensitive Risk Management Practices” 2000, Institute of International Finance, Washington, DC. (Winning Essay in the Year 2000, Jacques de la Rosiere, *Essays on Global Finance Competition*). Also Persaud A. “The Disturbing Interaction Between the Madness of Crowds and the Risk Management of Banks,” paper commissioned by the Commonwealth Secretariat, London, for the Conference on Developing Countries and Global Financial Architecture, June 2000.

[t]he extent to which FDI bypasses smaller and poorer countries is often exaggerated.

Going on to analyse briefly the role of PCF in financing development, ZPR draws the following conclusions:

- Developing countries need to continue improving their attractiveness to FDI through positive actions (i.e., by upgrading standards of accounting and auditing, transparency, corporate governance, and public administration, along with improved infrastructure and application of the “equal treatment with domestic firms” principle) rather than through tax concessions and lower social or environmental standards. Competitive tax concessions should be regulated and discouraged by an International Tax Organisation (ITO).
- Foreign investors in developing countries should subscribe to the UN’s Global Compact, which highlights nine principles for good corporate citizenship dealing with human rights, labour standards and environmental standards.
- The catalytic role of the MDBs in directing FDI to developing countries should be increased (Volcker Commission) through the provision of partial risk guarantees.
- FPI should be encouraged to diversify the number of options available to countries for financing development. However, such flows need to be properly regulated to avert the risk of macroeconomic destabilisation and financial crisis. To accomplish this goal, international financial architecture needs to be strengthened to reduce vulnerability. Furthermore, domestic financial systems need to be strengthened through stronger prudential norms and practices and better standards and codes in a number of areas.
- Developing countries need to be more pro-actively involved in the design and formulation of prudential norms and improved standards/codes because their implementation can be difficult and costly. Capacity-building assistance is required to implement improved codes.
- Private capital needs to be “bailed-in” for the management of financial crises by making collective action clauses a standard feature of sovereign bond issues and initiating “a queuing process” that would prevent or slow down flight exit.

- Artificial restrictions by industrial countries on institutional investment in emerging markets need to be removed.
- The prospect should be averted of the new Basle proposals for determining the minimum capital requirements for banks, which would make commercial bank loans prohibitively expensive for all but the most creditworthy developing countries.

ZPR's recommendations are unexceptionable and supportable, but they are too general, a feature that limits their practical value. SGR makes an even larger number of general recommendations on PCF (Annex 2). Neither of these recommendations provides a blueprint or menu for reducing the dependence of developing countries on official flows, which are waning, while increasing their reliance on private flows, which are increasing. Some of the recommendations made (e.g., creating an ITO or signing up to the Global Compact) may, in the short run at least, even militate against increasing PCF to developing countries by imposing additional costs on foreign investors who must meet wider obligations of corporate social responsibility.

Even for the poorest developing countries, PCF will increase in importance over time despite the occasional interruptions caused by episodic (but inevitable) financial turbulence. Therefore, it is essential that the developing countries propose more specific measures at the UNCFD to increase and broaden PCF as quickly as possible. This paper takes some steps in that direction with a brief initial digression *en route* on the overplayed distinctions between FDI and FPI.

The Linkage between FDI and FPI

Academic literature and the IFIs invariably overplay the dangers of FPI (portrayed as liquid, inherently volatile and unproductive because it does not finance new investment) relative to FDI (portrayed as stable, fixed and productive). These characterisations are simplistic and misleading. The imperatives of risk-management now incline treasurers of TNC affiliates in developing countries to maximise local borrowings against fixed and working capital assets. The liquidity thus maintained can be quickly shifted in a financial crisis to protect the real value of the original investment from depreciating. FDI can be made almost as liquid and as mobile as FPI.

Furthermore, risk-management instruments (especially derivatives for hedging against interest-rate and currency risk) in financial markets now permit corporate treasurers of TNC subsidiaries in the more advanced developing countries (representing the largest amount of FDI) to undertake off-balance sheet transactions (e.g., options, futures, swaps) in derivative markets. These can have the same net effect as FPI when it rushes to exit. Hedge contracts bought to protect the value of FDI can, when they are exercised in a financial crisis, amplify and exaggerate movements in exchange rates, interest rates and share prices, thus exacerbating the impact of a financial crisis.

On the other hand, some transactions recorded as FPI (e.g., share-purchases by institutional investors in green-field investments) and regarded as volatile by policy makers and regulators, can actually be a substitute for (or may actually accompany) FDI and be just as stable.

Thus, while conceptual differences in cost-benefit and volatility-risk profiles between FDI and FPI remain important in theory, their costs and dangers in practice can be (and frequently are) misconstrued. For that reason, it may be just as important for central banks and regulatory authorities in developing countries to monitor the short-term liabilities and off-balance sheet derivative and forward positions of major foreign direct investors (and of foreign commercial and investment banks) in their countries as it is to monitor flows of FPI and capital flight. In that connection, it should be noted that domestic corporations and domestic portfolio capital also behave the same way FPI does in exacerbating financial crises, regardless of controls on capital accounts.

A second feature is equally noteworthy. FDI and FPI are usually discussed as if they were two entirely separate activities unrelated to one another. Literature on foreign investment often suggests that FDI always occurs independently of FPI and *vice-versa*. It also suggests that developing countries should focus on attracting FDI, while being wary of FPI. These portrayals are valid up to a point. In practice, inflows of FDI are larger in emerging markets that also attract FPI and that have wide and deep secondary markets for financial securities (i.e., the kind of markets that are necessary to attract FPI). Related to this observation is the fact that (with a few notable exceptions) both FDI and FPI are concentrated in the larger, more industrially advanced, developing countries.

The apparent FDI-FPI link came about after 1990, when many foreign direct investors (and especially transnational corporations) began to design routes for realising the (market) value of an appreciating investment and reducing exposure risk once investments have matured. In many instances, if such a route is not in sight, FDI (particularly in manufacturing and services) may choose not to enter. FDI in mineral and hydrocarbon exploitation does not attach as much importance to early realisation of investment value in capital markets. It prefers instead to derive value from processing and marketing the off-take for longer periods of time.

The FDI-FPI link implies that large developing countries aiming to attract FDI must be prepared to attract FPI as well if they do not want to confront the limits to FDI growth before long. This implication holds true even though opening up to FPI (particularly through early capital account liberalisation) may initially expose some countries to higher degrees of financial and economic volatility, which suggests they quickly learn to manage. The implication is less appropriate for small countries whose domestic capital markets are limited by their size, but FDI in such countries is likely to be limited in any event, unless it is attracted by natural resources.

Secondary markets provide the easiest and most convenient value derivation and exposure risk reduction routes for FDI. Local public offerings of shares permit FDI to reduce equity exposure risk while deriving surplus value (through premiums on initial public offerings and shares traded in secondary markets) and retaining management control. Moreover, the presence of secondary markets (and of FPI) permits FDI to leverage itself more efficiently and to calibrate its equity (and currency) risk exposure when it comes to financing second-stage expansions, or mergers and takeovers. These considerations make FDI and FPI more interdependent than is generally recognised in economic literature, although this relationship is taken for granted by investment bankers and financiers.

Foreign Direct Investment

Since 1994, FDI has become the single largest source of *external* financing for *investment* in developing countries (Table 1). When attracted by sound macroeconomic policies, FDI has “crowded-in” ancillary investments and increased growth rates through the transmission of technolo-

gy and human skills and increased domestic competition and exports. Inflows of FDI have grown from 0.14% of the developing world's GNP in 1980, to 0.78% in 1991, peaking at 3% in 1998 before declining to 2.63% in 2000. In dollar terms they have grown from US\$4.4 billion in 1980 to US\$36 billion in 1991 and US\$185 billion in 1999 before dropping back to US\$178 billion in 2000 (Table 4) and falling further again in the first half of 2001. Despite that "hiccup," the overall increase has been remarkable.

The developing world accounted for a quarter of global cross-border FDI in 1999. Its share peaked at 36% in 1997 before the Asian crisis.³ It dropped to less than 16% of global FDI in 2000. Against that proportion, developing countries now account for 22.5% of world production at nominal exchange rates, and 45% at purchasing power parity (PPP). Given a presumed differential of 4-5% in sustainable long-term growth potential between the industrial and developing worlds over the next 20-25 years, the share of global FDI accounted for by developing countries should be, other things being equal, at least a normative 40% over that period.

The decline in the share of FDI absorbed by developing countries and the corresponding increase in the industrial countries' share, which rose from 65% in 1994 to 84% in 2000, is explained in part by the rapid growth in the US through the 1990s, which attracted FDI from Europe, Japan and developing countries like Korea and increased the US share of global FDI from 18% in 1995 to 26% in 2000. That shift may reflect a one-time re-allocation of global capital resulting from the significant increase in "knowledge as a key production input" and higher rates of return from globally linked investments in the information technology and communications industries.⁴ Over the coming decades, developing countries may also attract flows of technology-related FDI as technologies mature and low-cost labour and location advantages are re-asserted.⁵

3 The decline from 36% in 1997 to 25% in 1999 resulted partly from unprecedented merger and acquisition activity in the industrial countries in 1999 (UNCTAD, *World Investment Report*, 1999).

4 Feldstein M. "Aspects of Global Economic Integration," NBER Working Paper No. 7899 (2000). National Bureau of Economic Research, Cambridge, Mass., USA.

5 *Global Development Finance - 2001*, Vol. 1, *Building Coalitions for Effective Development Finance*, the World Bank, Washington, DC., USA, (pp. 38).

Growth in FDI flows to developing countries was boosted between 1992 and 1997 by one-off factors such as the privatisation of major infrastructure service companies in Latin America.⁶ In 1998-99, a large proportion of FDI in the developing world financed mergers and acquisitions (M&As) in East Asian economies.⁷ There remains scope for FDI motivated by privatisation in South Asia and Africa and for industrial rationalisation through M&As in these low-income regions.

Latin America and East Asia have accounted for 75-80% of FDI to developing countries since 1990. Eastern and Central Europe account for another 15%. Other regions receive only 5-10% of the total. Larger FDI flows to Africa and South Asia will depend on whether, and how quickly, these regions undertake the policy reforms and structural transformations needed to create more space for private participation in the economy. East Asia started on such reforms in the 1970s and Latin America in the mid-1980s, but even in these two regions much remains to be done.

On the whole, developing countries have made progress in improving the climate for FDI since 1990. They have eased or removed licensing requirements, opened sectors previously closed to foreign investment, increased limits on the share of foreign investment in domestic firms, liberalised current and capital account regimes for foreign investors, strengthened protection of intellectual property rights, improved regulation of domestic financial markets, and made tax systems neutral between domestic and foreign investors by extending equal treatment. Many countries have undertaken aggressive programmes of privatisation that have attracted large inflows of foreign capital (in the form of direct and portfolio investment). Most developing countries have fewer regulatory impediments to FDI than some of the OECD countries, but regional variations remain large with South Asia lagging farthest behind in the FDI stakes.

By and large, the countries that have made progress along these lines have witnessed increases in FDI inflows through the 1990s, although the correlation is by no means perfect. In some countries (especially low-in-

6 Available evidence indicates that privatisation of state-owned assets in Latin America and Eastern and Central Europe have yielded significant benefits especially in the infrastructure, industrial and financial sectors (GDF-2001 op. cit.) and resulted in significant amounts of new investment associated with privatisation.

7 Mody, A. and Negeshi, S. "Asian Restructuring and the Role of Cross-Border Mergers and Acquisitions" (2001) in Claessens, S. et. al. (eds.) *Resolution of Financial Distress*, World Bank, Washington, DC.

come ones), FDI has not responded to policy and procedural reforms to the extent anticipated. A low level of development, insufficient physical and social infrastructure, and the lack of market opportunity and natural resources in many countries are some of the reasons. Other reasons include corruption, failure to simplify regulatory requirements, complicated, non-transparent administrative procedures, and insufficient protection of property (and collateral recovery) rights due to malfunctioning legal systems that do not provide civil redress “in real time.” Corruption has a greater effect on FDI than on FPI: recent studies⁸ indicate a statistically significant link between corruption and opacity on one hand, and FDI flows on the other.

FDI: Fuelling A Race to the Bottom?

As globalisation has taken hold and developing countries have begun to participate in global trade and investment to an unprecedented degree, the spectre of a “race to the bottom” has been raised. There is concern that FDI in developing countries could cause an erosion of the labour and environmental standards the industrial countries have secured over the years. If global firms can lower costs by shifting production to countries where local standards and the laxity of their enforcement enable them to avoid costs they would incur in industrial countries, that impairs the competitiveness of countries with higher standards and diminishes global welfare.

Instead of a race to the bottom, emerging evidence suggests the reverse: FDI is resulting in higher standards and better enforcement. After incidents like Bhopal in India, local communities and global firms now see a common self-interest in improving and safeguarding higher health, safety and environmental standards. This realisation is reinforced by activist NGOs creating public demand for higher standards in the developing world and embarrassing firms not meeting their expectations. The growth of incomes and environmental awareness in developing countries are working together to increase local public demand for higher standards and better enforcement.

8 (1) Hoekman, B. and Saggi, K. “Multilateral disciplines for investment related policies” in Guerrieri, P. and Sharer, H.E. (eds.) *Global Regionalism and Economic Convergence in Europe and East Asia: The Need for Global Governance Regimes*, Institute for International Affairs, Rome, 1999; and (2) Drabek, Z. and Payne, W. “The Impact of Transparency on Foreign Direct Investment” (mimeo 2000), World Trade Organization, Geneva.

A global trend toward “ethical investment” is emerging, prompting institutional investors to reinforce higher standards. This trend is also reflected in the ethical investment indexes being derived in the stock markets in London and New York and throughout Europe. Similarly, ethical trading initiatives are being launched (e.g., by the present UK government), which are aimed at improving adherence to higher standards and corporate conduct in the developing world. FDI in TNC affiliates in the developing world (which accounts for the largest share of FDI) involves parent companies eager to protect their image as responsible corporate citizens with customers, shareholders and their non-executive (public interest) directors in industrial countries alike. Accustomed to higher environmental standards in their home countries, these firms have developed in-house technologies that incorporate them.

Analysis of pollution data in major urban centres across the developing world over the past 10 years suggests that despite large-scale FDI in polluting industries, there is a definite trend toward reduction of particulate pollution and improved air quality⁹. Similarly, TNCs in developing countries have been found to apply significantly higher labour standards (health, safety, working conditions, child care, health and education benefits, pensions and wages) than local competitors.

Public and official pressure on the boards and managers of multinational firms in home countries to apply high labour standards in their plants around the world is resulting in dual labour markets in many developing countries with detrimental overall effects.¹⁰ Domestic firms are becoming uncompetitive too rapidly without sufficient time or opportunity for adjustment and retooling. They generally have higher costs of capital and compliance than their foreign competitors in local markets. At the same time, they attract managerial and plant-floor labour with lower levels of education, skills and capabilities than TNCs, since their multinational competitors invariably outbid them for the best quality labour.

9 GDF-2001, op cit., Box 3.2, pp. 72. See Wheeler, D. “Racing to the Bottom? Foreign Investment and Air Pollution in Developing Countries.” (2001) World Bank Development Research Group Working Papers 2524, Washington, DC.

10 Such evidence was presented at the Conference on Corporate Responsibility in Montreux (May 3-5, 2001) organised by Wilton Park. The Conference was attended by high-level representatives of ten major TNCs with a global presence, executives of firms from developing countries, senior officials from the UN and from European and US governments, as well as academics and NGOs.

Thus, instead of a race to the bottom, the risk of unrelenting pressure through FDI to apply high labour and environmental standards immediately, without an adequate transition period for domestic firms to catch up, is resulting in a hollowing out of domestic competitive capability and entrenching the advantages foreign firms have (in terms of their access to capital, technology and other resources) in securing local and global market share.

The race to the bottom has occurred in another way as well, i.e., via untrammelled competition among developing countries to attract foreign direct investment through tax incentives. After several years of experience with tax holidays and other incentives, which have resulted in burgeoning domestic fiscal costs (through foregone tax revenues) but few commensurate benefits, a large body of research suggests that the provision of tax incentives by host countries is neither particularly effective nor beneficial in attracting either FDI or FPI.¹¹

Foreign Portfolio Investment

FPI takes four forms: (a) bond issues (sovereign and corporate) by developing countries, their public sector instrumentalities and private corporations on global bond markets; (b) commercial bank lending; (c) equity investments; and (d) a balancing item to reconcile discrepancies in recording such flows. *Table 6* shows gross FPI flows to developing countries surging from US\$80 billion in 1991 to a peak of US\$324 billion in 1997, before falling to US\$197 billion annually in 1998-99 (in the aftermath of the Asian crisis) and recovering in 2000 (to US\$250 billion). The corresponding net flows of US\$23 billion in 1991 rose to US\$119 billion in 1997, collapsed to US\$20 billion in 1999, and recovered to US\$67 billion in 2000, when crisis-affected Asian economies began to rebound.

Gross capital market flows to developing countries, however, are estimated to have declined substantially in the first half of 2001 (FH2001).¹² The prognosis for the second half of 2001 was even worse; especially after the events of September 11, 2001. Despite the substantial declines that

11 Oman C. *Policy Competition for Foreign Direct Investment: A Study of Competition Among Governments to Attract FDI* (March 2000, mimeo); OECD Development Research Centre, Paris.

12 *Recent Trends in the Transfer of Resources to Developing Countries* (paper prepared by World Bank Staff for the Development Committee; DC/2001-0022, August 21, 2001).

occurred in global interest rates throughout 2001, the average spread on developing country bonds over prime dollar rates increased by 1.8% with spreads on the bonds of Argentina and Turkey widening by 13.5% and 8.5% respectively. Although bond placements from developing countries increased modestly in FH2001, that pattern was reversed in SH2001 when the severe debt service problems that emerged in Argentina resulted in efforts to reduce debt service burdens through a bond exchange. Commercial bank lending to, and equity placements from, developing country enterprises declined dramatically in 2001 with the bursting of the technology stock bubble in 2000 and the deteriorating performance of emerging equity markets.

These annual fluctuations demonstrate how volatile FPI can be; a characteristic that applies to every component of FPI but mostly to commercial bank lending. Another feature of FPI is that, for obvious reasons, it is concentrated in developing countries with advanced capital markets.¹³ The FPI share of middle-income countries is over 96%; with 85% of FPI concentrated in ten countries. Net FPI in 2000 recovered from its lows of 1999 and increased by US\$46.6 billion. FPI in five countries (Brazil, China, Korea, South Africa and Turkey) increased by US\$54 billion, but FPI to the rest of the developing world decreased by over US\$7 billion. FPI flows in 2001 (especially in equity placements) were expected to be significantly lower and just as concentrated.

FPI and the Increased Need for Reserves: Before FPI flows began burgeoning in 1991, reserve holdings by developing country central banks were less than US\$225 billion. These holdings had increased nearly four-fold by mid-2001. The stock of FPI held by foreign investors in the equity and debt securities of developing countries was estimated at the end of 2000 to be just over US\$1 trillion, although the market value of that stock (which is actively traded) fluctuates considerably; in October 2001 it was probably 20-30% lower. Against these claims on their public and private financial assets by foreign portfolio investors, developing countries in mid-2001 held international reserves (mostly in US dollars with the balance in SDRs, gold, Japanese yen and Euros) of over

13 The exception is China, which has been able to attract an enormous amount of portfolio equity investment, although its capital markets are not as well developed as, for example, India's and far behind South Africa's.

US\$850 billion. Most of these reserves were held by developing countries in East Asia with Greater China (i.e., China, Taiwan and Hong Kong) holding over US\$450 billion.

Looking at flows rather than stocks (i.e., at annual FPI flows to developing countries vs. changes in their international reserve holdings) *net* FPI flows between 1991-2000 averaged an annual US\$67 billion (Table 6). These were almost fully offset by increases in international reserve holdings by developing countries, which averaged US\$62 billion annually over the same period.¹⁴ To some extent, increasing FPI has resulted in increasing the perceived need on the part of developing country central banks to hold larger reserves as a bulwark against FPI-induced capital account volatility destabilising their economies. The nearly 1:1 ratio between annual averages of net FPI flows and increases in reserves across the developing world is, however, surprisingly large. In developed countries, unrestricted access to FPI usually diminishes rather than increases the need for reserves.

Neither reserve holdings nor FPI are costless. When reserves are held in safe securities (e.g., US treasury bonds) nominal returns through the 1990s (and especially in 2000-01) were quite low and real returns even lower. When reserves are accrued through foreign borrowing rather than accumulation of trade surpluses the net effect is a negative return (ranging between 2% to 8%).

Many in the development community perceive FPI to be undesirable not only because it is “unproductive” (in the sense that unlike FDI it does not finance new investment) but also because it requires additional reserves to be held, and is presumed to result in excessive speculative gains being made by foreign portfolio investors, particularly in times of financial crises induced by inward and outward surges of FPI. On the last issue, however, the facts suggest that total returns on FPI in emerging markets have been negative over the past five years [1997-2001, ed.], based on the IFC indexes on FPI equity investments, and movements of bond prices and spreads in emerging markets. These losses resulted in inflicting significantly larger net costs on foreign private investors (especially institutional investors) than the incremental costs incurred by developing country central banks in holding larger reserves to cope with the consequences of sudden FPI outflows.

14 GDF-2001, op. cit., Table 2.1.

How Valuable is FPI? Taking these realities into account, interesting questions arise about what the net benefits of FPI were for portfolio investors, for individual countries, or for the developing world as a whole, over the past decade. These questions need answering urgently. It may be hypothesised that between 1991-2001 the financial and economic costs of FPI for developing countries exceeded its anticipated benefits. Such a hypothesis would need to be confirmed by rigorous analysis. With FPI representing the thin end of the wedge of incipient financial globalisation and market integration, its proponents argue that short-term hiccups notwithstanding, significant benefits materialise in the medium and long term; especially as emerging capital markets develop and become stronger and more resilient, with improved standards of operation and regulation, and with the kind of institution and capacity-building that can only occur with time and experience.

Beyond that point, the benefits developing countries are likely to derive from FPI should be similar to those now being enjoyed by developed countries. The openness of their capital markets to large unrestricted two-way flows of FPI enables developed economies to adjust very swiftly and relatively painlessly to evolutionary changes as well as to unforeseen shocks in domestic and international economic circumstances. Unlike developing countries, they are able to adjust without recourse to official financial support from IFIs to avert, or cope with, financial crises. Thus, they can avoid the conditionality and infringement of economic sovereignty that accompanies such support. An example of the stark difference between developed and developing economies in this respect was provided by the relatively painless adjustment of European economies, which enjoyed unrestricted access to FPI, to the ERM crisis of 1992, as compared to the unnecessarily painful and damaging adjustment that the more dynamic and open East Asian economies had to endure through the financial crisis of 1997-98. These countries were obliged to resort to official IFI support when FPI exited in panic.

Bond Market Flows to developing countries were halved from the level of 1997 and stagnated at around US\$72 billion between 1998 and 2000 (Table 6). Net flows, however, showed a small recovery in 2000 over the previous year but remained at less than half the peak of 1996. In FH2001, the volume of bonds issued by all developing country borrow-

ers increased by 10% over FH2000 when Brazil, Colombia, Croatia, South Africa and Uruguay issued bonds in European and Japanese markets when US bond markets suddenly became risk-averse. At the same time, access to bond markets by countries whose fundamentals deteriorated (Argentina, Ecuador and Turkey) was dramatically curtailed. Bond issuance by developing countries in SH2001 was expected to be significantly lower because of (a) reduced demand for funds on the part of stronger economies responding to the onset of a global slowdown in trade and consumption; and (b) increased risk aversion on the part of global investors for holding the bonds of countries with poor fundamentals. Most bond market flows have remained concentrated in Latin America and Eastern Europe since other regions do not have significant exposure in these markets. This situation needs to be rectified. Multilateral institutions could do so by using their guarantee powers to introduce more developing country issues in global and regional bond markets in a phased manner over the next decade.

Commercial Bank Lending is the main private portfolio capital flow for low-income countries and for lower-rated or unrated corporate borrowers from all developing countries. Such lending has declined steadily since 1997. In addition to the increased borrowing costs and heightened concerns about credit risks that have persisted since then, evidence of credit rationing emerged in 1999-2001.¹⁵ The stock of outstanding short-term debt owed by all developing countries fell marginally from US\$406 billion in 1999 to US\$402 billion in 2000, while the stock of medium-term debt owed to private banks fell by US\$38 billion. Low-income countries account for 15% of total commercial bank lending to the developing world. Their outstanding stock of short-term debt remained unchanged over the past year [2000] while their stock of medium-term bank debt fell by about US\$15 billion. In FH2001, commercial bank lending declined by 45% over FH2000. Global banks have reined in their lending sharply after suffering significant losses on their exposure to the telecommunications and IT sectors in developing countries. East Asian countries have reduced their dependence on commercial bank borrowings since 1997-98, while banks have also reduced exposure to oil exporters.

15 *GDF-2001* op. cit., Box 2.5, pp. 48. See Mody, A. and Taylor, M. "Disequilibrium Model of International Capital Flows," World Bank, Washington, DC. (forthcoming; draft mimeo, 2001).

Foreign Portfolio Equity (FPE) Flows represent the most important segment of FPI to developing countries over the long-term. In contrast to declining debt flows, FPE has quadrupled from US\$8.6 billion in 1998 (5% of total FPI) to US\$34.8 billion (15% of total FPI) in 2000 at a time of acute uncertainty in global financial markets. The increase was fuelled by: (a) investment in technology stocks in many developing countries, piggy-backing on a similar rise in industrial countries, although that was reversed in 2001; (b) a number of American Depository Receipt issues (ADRs are effectively shares issued on American stock exchanges) by firms in developing countries, thus opening access to and lowering transaction costs substantially for a wider investor base in the world's largest source market for FPE; (c) further reductions in transaction and agency costs resulting from improved communications across markets; and (d) increased liquidity through improved global market-making in emerging equities.

However, international equity placements by firms in developing countries in FH2001 dropped by 62% over FH2000 reflecting in large part the unwillingness of global investors to increase exposure after suffering significant losses in emerging equity markets in 2000-01. Such markets, especially in the information and communication technology sectors (which had attracted a significant proportion of equity investment between 1998-2000) mirrored the declines that occurred on NASDAQ.

Like all foreign portfolio investment, FPE flows are highly concentrated. In 2000, four countries (Brazil, China, Mexico and Turkey) accounted for 85% of FPE. In FH2001, only two countries (China and South Korea) accounted for over 60%. Nevertheless, equity flows hold promise for a larger number of middle-income (and industrialised low-income) countries that can support viable stock markets of their own as well as for smaller countries that participate in efficient and accessible *regional* markets. Equity flows are not as volatile as debt flows. They do not "mature" and do not need to be redeemed at any point in time; i.e., they have no "rollover risk" involved. If equity investors sell their holdings during a financial crisis, they take large losses; a factor that may incline them toward longer time horizons than providers of debt.

FPE investors have not, on the whole, had short time horizons in limiting exposure for quick returns. Nor have they realised returns between 1991-2000 that would imply a transfer of real resources from developing to

developed countries on the FPE account. Between 1996-2001 the returns on FPE in most emerging markets were negative. The net transfer that has occurred on the FPE (and FPI) account was in the other direction. Some global institutional investors do adjust their portfolios on a quarterly basis but there is no evidence to suggest that doing so has either increased their returns or made them net extractors of real resources.

Domestic Factors Influencing FPI Flows: The domestic factors that influence portfolio investor perceptions and inclinations (and thus determine FPI flows) are the same as those encapsulated in the sovereign risk rating of a country's debt obligations, which influences the views of equity investors as well. They take into account: immediate and medium-term growth prospects; debt and debt service constraints; the risk imposed by short-term debt; risks in the cash flow streams of current and capital accounts; the soundness, sustainability and consistency of macroeconomic policies (i.e. fiscal, monetary, exchange rate and trade); the size and financial sustainability of fiscal and current account deficits; political stability and associated risks; labour market flexibility or rigidity; and the level of foreign reserves and liquidity. Since the Asian crisis, ratings for developing countries have fallen across the board with upgrades being more cautious and taking longer to initiate than downgrades. Increasing importance is being placed on the availability of liquid foreign reserves to cope with financial shocks and on the level of non-performing assets in domestic banking portfolios. The soundness, stability, and extent of government ownership involvement (considered a negative) and political interference in domestic financial systems is also featuring more importantly in the assessments of portfolio investors.

External Factors Influencing FPI Flows: The following external factors have the greatest effect on FPI to developing countries: (a) rates of income growth in industrial countries; (b) rates of growth in world trade that affect demand and supply for new cross-border capital flows; (c) movements in global interest rates and especially in key US dollar interest rates; (d) relative returns on and volatility in portfolio equity and debt investments in industrial economies; (e) investor perceptions of country risk and financial system stability; (f) perceptions of neighbourhood or cross-regional contagion risks; and (g) periodic shifts in the exposure preferences of global investors between risk-taking and risk-aversion, and between income vs. capital gain.

Such shifts can be brought about either by changes in the quarterly performance of their overall portfolios or by longer-term changes in strategy.

The Potential Impact of FPI: FPI is sought by developing countries because it provides them with greater flexibility, liquidity and less conditionality in their external financing options, thus facilitating (ostensibly) management of their external accounts. However, liquidity makes FPI volatile. Capital markets do not impose overt conditionality in the way that official financiers do. But they demand high standards of voluntary adjustment and reform, and of macroeconomic policy consistency and stability. They respond skittishly to unsustainable policy twists or to sudden or creeping policy failures. They can induce financial crises by surging inwards to take opportunistic advantage of quick returns (e.g., via high domestic interest rates or a ballooning stock market) while planning an early exit just before those bubbles burst (e.g., when it becomes apparent that a fixed exchange rate cannot hold or that stock market valuations cannot be sustained).

The volatility of FPI affects a handful of developing countries directly. It affects more countries indirectly through contagion when countries that have been cautious about attracting FPI get caught in the backwash.¹⁶ The financial crises triggered in the developing world in the 1990s have all been linked to surges of FPI; first inward then outward, exacerbated by over-indulgence in short-term foreign bank borrowing by domestic corporations. Inward surges can, in the absence of sound reserve management and sterilisation strategies, have an impact on expanding local money supply, and emit signals on exchange and interest rates that are contradictory. These become disconnected with prices and wages in the real economy and fuel the growth of an unsustainable cycle which leads to generalised price inflation or inflation in asset values, inducing investment in unproductive assets (e.g., property), and consumption booms triggered by asset prices. In these circumstances, exchange and interest rate signals quickly diverge from economic reality.

¹⁶ For example, in 2001, there was a significant contagion effect on all developing countries, regardless of their fundamentals and performance, as a consequence of deteriorating conditions in Argentina and Turkey. The correlation between interest spreads in selected countries that are part of the global Emerging Market Bond Index and those of Argentina and Turkey increased dramatically in July 2001. Also, the high and narrow range of these correlation coefficients suggests that global investors are not making sophisticated distinctions between developing countries whose fundamentals are sound and whose credit ratings are good and those that pose substantial risks of continued deteriorating performance. [WestLB Market Research: Trends in Emerging Bond Markets, October 18, 2001].

Once triggered, these booms are difficult to rein in by orchestrating finely tuned soft-landings. Instead they result in economic dislocations (or hard-landings). When the probability of such dislocation rises, FPI makes a dramatic exit, triggering a run on reserves. To combat reserves being drained interest rates are raised (under IMF/WB pressure) to protect exchange rates and stem capital outflows. The squeeze induces a collapse of asset values leading to distortions on corporate balance sheets that trigger bankruptcy and unemployment. It strangles investment (public and private) and brings about a recession. Sudden economic implosion puts pressure on an over-stretched fiscus (by reducing revenues and increasing expenditures simultaneously) that cannot take further strain. In such circumstances the bottom falls out of fiscal, monetary and exchange rate policy, with the government losing control over these levers of economic management. Resorting to the IMF results in the imposition of harsh stabilisation conditionalities that make matters worse in the short-term before the economy bottoms out and begins a long, painful recovery.

Volatility of FPI and Capital Account Opening: Surges of PCF in fragile financial systems have proven to be explosive in the early stages of liberalisation. Premature (i.e., out-of-sequence) financial liberalisation has resulted in domestic markets not being able to handle either the large influx of FPI that occurs when capital accounts are opened, or the large outflows that are precipitated in a financial crisis (that open capital accounts cannot stop). For these reasons, earlier proselytising about the merits of liberalising capital accounts early during adjustment and reform has been revisited. Current wisdom suggests that capital accounts should be liberalised only *after* financial system reforms have eliminated imperfections that characterise (government dominated) financial systems in developing countries. Domestic banks and capital markets need to function efficiently before their integration with global financial markets is induced.

However, this rule should not lead to complacency about the pace at which capital account liberalisation should occur. Failure on the part of governments to strengthen their financial systems rapidly, in order to open their capital accounts within a conscionable period, can lead to prolonged periods of domestic financial instability. Governments then end up subsidising non-performing assets and financial institutions (usually government-owned) indefinitely and not taking the decisive actions that

are necessary for substantive reform to occur.¹⁷ Such an approach can debilitate domestic financial systems and deprive countries of access to adequate FPI to their detriment. Also, FPI outflows and domestic capital flight can still occur through the grey market even when capital accounts are controlled; although the risks and frictional costs involved tend to reduce their size.

The experience of the developed world after capital account opening in the 1970s has shown that when domestic financial systems function as they should, access to global FPI dampens rather than exaggerates volatility. However, it needs to be remembered that even developed countries had problems with managing financial crises in the 1970s, when countries like Britain and Italy had to resort to IMF support. In the event of an external financial shock, seamless and immediate access to external liquidity from global capital markets cushions and slows down declines in consumption and asset prices. That happens now as a matter of course in industrial countries. In practice, the experience of the 1990s in developing countries has been the opposite. PCF have been *pro* rather than *counter* cyclical because domestic financial systems do not function in the way they should. The volatility of PCF amplifies changes in consumption, output and public expenditure when the domestic financial system is too weak to act as a buffer.

With experience on the part of the authorities and of domestic financial institutions, emerging evidence suggests that volatility can be managed and stability achieved within a few years. In that sense, developing countries in the 1990s were on the same part of the learning curve (for coping with financial crises) that developed countries were in the 1970s. While the economic cost of PCF volatility can be substantial, PCF volatility for developing countries as a whole did not increase between 1991-2001, although volatility in particular regions remained high.¹⁸ Countries that have received

17 India provides a classic case of this syndrome. Since 1997 it has been congratulating itself for having escaped the worst effects of the Asian financial crisis because its capital account remained partially closed. Its complacency on that front, however, has led to several *internal* financial crises occurring since then, resulting in the insolvency of many large public-sector banks and repeated failures in capital markets caused by a series of "scams" in which public sector financial institutions have been implicated. The direct costs of propping up its woefully inefficient financial system have been estimated at about US\$5-6 billion in recapitalising banks that remained fundamentally insolvent and a further US\$2-3 billion in covering the losses of public asset management institutions.

18 *GDF-2001*, op. cit., pp. 74-75.

FPI since the early 1990s have learnt how to manage volatility and rebounded quickly from crises (e.g., East Asia post-1998) partly because of greater exchange rate flexibility and capital mobility. More countries have built up reserves substantially and arranged prophylactic credit lines to be activated to manage liquidity in the face of sudden capital flows.

Managing FPI Flows Better at Source and Destination: Many lessons have been learned about how to manage surges of FPI and to combat market failure when herd instincts govern inward and outward flows. However, there remains a reluctance on the part of *developed* country governments to consider ways of moderating hot FPI flows at source; especially during the inward surge (for the receiving country) part of the cycle, through a system for hoisting yellow and red flags (i.e., in the same way that central banks in OECD countries signal the dangers of commercial bank lending to over-borrowed developing countries through a risk matrix for prudential provisioning). For example, in mid-1996 when the IMF was signalling its concern about the deterioration in Thailand's economic fundamentals, OECD regulators in securities markets could have acted to warn institutional investors of the concerns expressed and required *ex ante* prudential provisioning for loans, bond holdings and portfolio equity investments undertaken by their asset managers and banks in Thailand. Had they done so, the Thai crisis might have been averted. Instead, institutional investors and commercial banks took no heed of the IMF's warnings (which were known to governments) and behaved in a manner that made the crisis virtually inevitable.

When opportunistic (usually sophisticated) institutional investors such as hedge funds and global banks take advantage of twists in interest and exchange rate signals¹⁹ and precipitate a financial crisis, their funds should not be permitted an automatic exit through the typical IMF/WB bail-out. Official regulatory circles have come to that conclusion belatedly in the aftermath of the Asian crisis. Options are now being considered that are likely to change the management of future crises. OECD financial regulators and the IMF have recognised that a moral hazard risk has been

¹⁹ This was the case in Thailand and other Asian countries in 1997. They seemed to be signalling a *de facto* fixed exchange rate guarantee against the US dollar although their domestic interest rate was much higher than the US interest rate. That was an invitation for hot foreign (and round-tripped domestic) capital to flood in to take advantage of a higher interest rate return while being assured (supposedly) of a fixed exchange rate.

created on the part of FP investors and banks with the way in which financial crises have been managed so far. That approach has encouraged repeated market-failure through bail-outs of private investors and commercial banks that have deliberately taken speculative exposure in high-risk situations, comfortable in the knowledge that they will be bailed out. Thus, the IMF/WB financed rescues, which were organised to avert systemic risk, ended up inducing it instead.

The gravity of the problem and the necessity to do something to ameliorate it has been recognised; now care must be taken that neither developed nor developing countries act in ways that reduce or impair the flow of private capital. If developing countries are to grow faster than industrial ones, global capital has to be permitted to flow with as few restrictions as possible to opportunities for high returns and to take the attendant risks. Such flows must be based on the understanding by investors and developing countries that certain risks will materialise and that some individual investments will fail. That is how markets work. Safeguards cannot be provided against all investment failure; however, situations do need to be averted where systemic risk is created that induces financial systems to fail.

Learning from Unconventional Experience: In that context, Malaysia's experience (and Hong Kong's in intervening in the stock market to deter harmful speculation) offer case-studies for intervention that other developing countries need to consider. Malaysia's approach eschewed resort to the IMF. It designed its own adjustment programme. An initial devaluation was followed by a fixed exchange rate regime with controlled domestic interest rates and re-imposition of temporary controls on FPI. Malaysia avoided an unnecessarily harsh fiscal and monetary squeeze of the kind that damaged the rest of Asia. Its approach was effective in bringing about adjustment without the destruction experienced in Indonesia and Korea. Similarly, Hong Kong's monetary authorities intervened in the equity market to burn speculative investors indulging in double-plays (explained below) that may have led to a financial collapse in Hong Kong.

Countering Speculative Double and Triple Plays: During the Asian financial crisis (1997-98) some foreign institutional investors and banks undertook simultaneous transactions (in derivatives and physical segments of capital markets in Korea, Hong Kong, Malaysia, Thailand and Singapore) that drove interest rates up and currencies down, while short-selling equi-

ties and equity-indexes in those markets. The net result was to make extraordinary profits when equity prices collapsed in the face of a draconian interest-rate rise and currency collapse. Countering such speculative plays requires unconventional official intervention in markets of a kind that speculators have not anticipated and that results in large losses for them. Using markets to burn speculators is more effective than attempting to remedy such practices by fiat (e.g., banning short sales). While such action by governments requires resort to large reserves, this is an area where the provision of liquidity by the IFIs to permit governments to take such action would be justified and should be considered.

Remedial Options for FPI-Induced Crisis Management: It may be premature to reach agreement on an internationally co-ordinated regime involving direct interaction among governments and financial market regulators (rather than the intrusive and heavy-handed intermediation of the IMF and World Bank) to govern the behaviour of FPI. Nevertheless, the world community would be negligent if it did not flag this issue at UNCFD and embark on a programme that would result in better approaches by the IFIs with more acceptable outcomes.

The aim should be to avert the frequent recurrence of financial crises in the developing world and ensure that the eventual costs of dealing with crises are borne symmetrically by portfolio investors (domestic or foreign), by foreign and domestic banks, and by the country and entities concerned with receiving such investment or borrowing. The continuation of crisis management protocols that still provide preferential treatment to foreign investors and foreign banks, allowing them to go to the head of the “exit queue” during a crisis, and encourage them to drain a country’s reserves, should be discouraged.

Thought should also be given to requiring investors and foreign banks interested in portfolio investment to purchase appropriately designed prophylactic derivative contracts, e.g., on currencies, equity indexes and interest rates, that would discourage them from indulging in counter-productive speculation through double or triple plays in equity, debt and currency markets in the midst of a crisis, thus exacerbating it. Such contracts (e.g., in derivatives such as options or futures on currencies and interest rates tailored to automatically trigger large losses for foreign portfolio investors if they undertake speculation to move currency values sharply downwards or

interest rates upwards within a specific time period) could be required as a contingent liability to be undertaken by foreign portfolio investors on initial entry and rolled over periodically.

At the very least, such requirements would reduce hot money flows and make portfolio investors think twice about opportunistic entry into nascent markets to make quick killings by exploiting the inevitable imperfections present in undeveloped financial markets. The theory that underpins designing and pricing such derivative contracts is well established and understood in sophisticated financial centres but not sufficiently as yet in emerging markets or in their treasuries and central banks. The World Bank could play a useful role in transferring such knowledge. Enough has been learned to make this possible in practice, providing sufficient political will exists to implement the measures needed, to design appropriate instruments, and to engage global investment banks and IFIs in providing the necessary counter-party risk-taking facilities.

Apart from discouraging double-plays, the management of FPI induced crises should avoid destabilising developing country governments or using financial crises as opportunities to effect political regime changes (as seemed to be the agenda in Indonesia). IFIs should be prevented from inflicting unnecessary pain through a plethora of often irrelevant conditionalities, which they often do in the belief that it is essential for them to convince markets that they are being suitably harsh and disciplinarian, or simply because they have not thought things through carefully enough.

Stimulating PCF to Developing Countries: Options and Mechanisms for Official Support

To increase PCF to developing countries and improve their distribution across countries and regions, a number of measures can be taken by governments and multilateral institutions (and their affiliated investment corporations) to encourage private capital flows.

Tax Breaks for PCF to Emerging Markets: Industrial and developing countries can take actions to enhance *push* (i.e., encouraging private capital to flow outwards from OECD countries) and *pull* effects (providing an attractive environment for private capital to come into developing countries). Industrial countries can encourage PCF to emerging markets through tax credits, deductions and allowances both for capital investment in the least developed countries (which could be treated on a par with either charitable

deductions or incentive-driven investment) and for income derived from such investments until these countries have reached developed status. Special differential tax treatment could be applied to both capital investment (through capital allowances in the form of tax credits or deductions) and the receipt of profits and dividends by corporate as well as individual investors in emerging market funds (whether for a country, a region or the emerging market universe as a whole). In the latter case, tax-benefits to mutual funds and asset management companies investing in emerging markets could be passed through to individual unit-holders. Clearly, such tax measures would need to be calibrated to provide maximum tax benefits for investments flowing to the poorest (and the highest risk) countries with a tiered reduction of the special treatment accorded to investment in more developed, middle-income emerging markets.

Three caveats are necessary when considering whether industrial countries should encourage greater amounts of PCF to developing countries through tax incentives at source. *First*, experience with differential tax treatment to achieve social, development, or environmental objectives (domestic or international) within developed countries is mixed. Studies in a number of developed countries suggest that the tax revenue foregone (i.e., the cost of providing the impetus) is rarely worth the benefit derived in most instances. Nor is tax-incentive driven investment necessarily efficient or productive. *Second*, the tax incentives provided by host countries to foreign investors have not been efficacious. They have resulted in counter-productive competition among developing countries in attracting FDI and FPI with beggar-thy-neighbour outcomes.²⁰ *Third*, when developed countries provide tax incentives to encourage PCF to developing countries, the cost of providing such tax-breaks is *socialised* (because it is incurred by the fiscus of the source country) while the immediate gain accrues to another country and is *privatised* at both ends (i.e., the benefit accrues to private investors in source countries and private firms in destination countries).²¹

20 Oman, op. cit.

21 Tax breaks provided by developed countries at the time of investment and on income from such investment may not always represent a total loss of tax revenue in perpetuity. When these investments yield returns and become taxable as host countries reach developed status, some gains will eventually be derived by the OECD country providing the tax breaks; i.e., by way of a reverse flow of repatriated capital, profits and dividends that would eventually become subject to tax. In such instances tax-breaks would represent revenue deferral rather than revenue loss, although the time period over which such deferral may occur may make the point moot in specific instances, e.g., in the case of investment in low-income countries.

Nevertheless, available evidence also suggests that, regardless of eventual outcomes, tax breaks do influence investor behaviour in developed economies. If productive investment in the developing world is to be privately financed in the future (for reasons that have been discussed earlier and for reasons of efficiency as well as funding availability) then developed countries need to do more to encourage such flows to developing countries through stronger push effects instead of relying exclusively on what developing countries might do to increase the pull effect. It should then be left up to developing countries (to provide the right macroeconomic and overall investment environment) and to private investors (to ensure the right microeconomics of investment) to ensure that ensuing investment is as productive and efficient as possible.

Despite the three caveats mentioned above, there may still be a case for OECD countries to provide special differential tax treatment to encourage PCF to the developing world for a transient period. That case is bolstered by the desultory aid performance of those OECD governments that have fallen far short of meeting the 0.7% GNP target for their ODA effort. Many large donor countries find it politically or fiscally difficult to make a greater official aid effort. They might find it easier to provide tax incentives for private investment flowing from their countries to the developing world. Meeting the present aid target would require raising tax resources or increasing domestic borrowing to finance incremental ODA outflows. Since PCF contribute to financing for development (although they are not a perfect substitute for ODA, private investment may in some instances do more for development than ODA has managed to do) there may be justification for providing tax breaks and counting them as an “aid equivalent” if that lessens pressures on some donor countries to provide amounts of ODA that are fiscally or politically infeasible. Taxes raised to finance ODA or taxes foregone to encourage PCF are, in a conceptual sense, equivalent.

Asking OECD countries to make a major effort to encourage PCF to developing countries is unlikely to be beneficial unless the latter create the right environment not only for attracting PCF but also for ensuring that they are effectively deployed. That no longer means providing tax holidays to compete with other developing countries in attracting foreign investment. As observed earlier, the value of tax breaks at the receiving end has

been played out as an attraction.²² Furthermore, foreign investors are less interested in tax breaks in destination countries than in having a business climate in which they can operate without wasting time, effort and money. They are more interested in a long-term entry that enables them to compete for domestic and global market share.

While developed countries might enhance the push effect on PCF through well-designed tax incentives, developing countries need to enhance the pull effects by delivering on the wish-list elucidated in ZPR: (a) eliminating corruption and rent-extraction; (b) putting in place effective and timely mechanisms for dispute resolution and global standards of judicial recourse, as well as collateral recovery and closure; (c) changing laws, rules and regulations that constrain normal commercial market activity, such as the right to engage or release workers based on market conditions and the profitability and economics of the firm, without being hindered by labour laws, or the right to purchase commercial and residential property, or the right to borrow and raise equity locally; and (d) increasing investment in infrastructure at a more rapid pace than might have been necessary without the pressures of globalisation.²³

Suffice it to say that neither push nor pull effects can be created overnight, but that should not stop developed or developing countries from doing in the short-run what is necessary for the long-run. In the short-run, accelerated private flows to many developing countries may create more problems than they resolve, but in the long-run, PCF are indispensable, if the pace of development is to increase and be sustained.

22 Oman, *op. cit.*

23 It has been argued that such a wish-list confuses pre-conditions for foreign investment with outcomes of such investment. The argument suggests that developing countries know *what* needs to be done but not *how* these desirable conditions should be brought about. That argument is confused sophistry. It poses a question that cannot be answered generically. How any country brings about necessary changes in the behaviour of its people, polity, judiciary and institutions is a country-specific matter. It is not as conceptually or practically difficult as the argument makes it out to be. Issues such as corruption, the lack of justice, ineffective judicial systems, the absence of market-friendly labour laws and of infrastructure are not intractable problems. To portray them as endemic in defining the “developing country condition” is neither helpful nor useful. Developed and developing countries have proved over time that these shortcomings can be rectified. If *what* needs to be done is accepted as necessary, then *how* it should be done can be learned by distilling from experience elsewhere and adapting available knowledge about various options to meet country-specific characteristics and constraints. The basic problem that needs resolving is the problem of how a developing country’s polity (usually prone to rent-seeking) interacts with its society and economy, but that is not a subject this paper with its limited scope can possibly tackle.

Encouraging Further FDI Inflows to Developing Countries: The Role of MDBs

The obvious impediments notwithstanding, there is much that can be done about encouraging greater flows of FDI to developing countries, especially the low-income and least developed groups, despite their drawbacks as destinations. The central problem pivots around risks in these groups of countries exceeding (or being perceived as exceeding) those that private investors are prepared to take because of conditions prevailing in these countries. This problem requires more imaginative combinations of risk-sharing between private and official capital in these countries to overcome the reluctance of private investors. With the knowledge and capacity that exist in the private sector, it should be possible for MDBs (and their affiliated investment corporations such as IFC) to design project-specific as well as generic schemes for various types of risk-unbundling and risk-sharing that pave the way for PCF to enter countries where they otherwise might not be prepared to take full exposure risk on their own. The World Bank has opened the door to partial policy risk guarantees, but neither private investors nor developing countries are rushing through it. That may suggest problems with the way in which guarantee operations have been handled by the Bank rather than with the concept of or need for imaginative forms of risk cover.

Although the value of the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for the Settlement of Investment Disputes (ICSID) has been advertised, their impact has been minuscule in encouraging incremental PCF. MIGA offers sovereign risk insurance, while ICSID settles investment disputes between foreign investors and member nations. Their operations are too small to suggest that they play more than a marginal (almost irrelevant) role in encouraging larger amounts of PCF to flow to developing countries; or in encouraging such flows to go to countries where they otherwise would not go. These agencies are not addressing the key blockages to expanded flows of PCF. Private investors also have difficulties with the bureaucratic and ponderous way in which these agencies work.

All the MDBs (and their investment affiliates) need to be encouraged to develop bolder schemes for supporting PCF – through tailored risk-cover guarantees, tailored derivative contracts aimed at hedging risk, and equity-

risk sharing by their investment affiliates – especially to low-income and least developed countries. Such activity should be given higher priority by the MDBs than making direct loans. At least 65% of the operations of MDB-related investment corporations (MDB-ICs like the IFC) should be concentrated in low-income and least developed countries instead of 75% of them being in middle-income or industrialised low-income countries in which FDI flows of its own accord without needing help. Such corporations often take the easy way out by preferring transactions in countries that do not need them (often annoying the private institutional investors they displace by doing so) on the grounds that these transactions are necessary to retain the quality of their portfolios. That argument has some merit to a point, but it is grossly overused.

There is a case for MDBs and their investment affiliates being more pro-actively involved in FDI inflows to low-income and least developed countries by acting as spearheads for unfinished privatisation; especially in South Asia, Central Asia and Africa as well as in the small developing island states (SDIS) of the Caribbean, Indian and Pacific oceans. As Latin America and East Asia have demonstrated, major opportunities exist to increase FDI in other regions by proceeding with privatisations that MDBs/ICs can kick-start. MDBs should take the perceived high initial risks (on equity and debt) accompanying such transactions. They can do so through financial engineering assistance and creating instruments (e.g., convertibles and call options on shares) to facilitate corporatisation of these enterprises (i.e., their restoration to profitability) before flotation.

Such transactions are unlikely to succeed unless MDBs/ICs bring in private operating partners (as well as private investment banks) that have a global stake in particular areas of infrastructure (electricity, telecommunications, broadcasting and media, water supply, sewerage and waste disposal, and all types of transport services – air, waterborne and land – as well as infrastructure provision such as toll roads, bridges, tunnels, ports and airports). The same applies in privatising industrial units usually found in the public sector (e.g., in food and beverages, in heavy industries like cement, steel, metals refining and beneficiation, oil/gas, coal, chemicals and petrochemicals, and in textiles). The overall design under which private operators are brought in to revamp and manage these services, while MDBs/ICs take the bulk of the initial capital risks, should eventually result

in the private partners exercising options to assume equity control once various kinds of risks have been reduced to levels that private investors feel comfortable with.

Privatisations do not result simply in a change of asset ownership, with no new investment taking place. Instead, experience suggests that privatisation triggers waves of new investment as new owners seek to upgrade and modernise run-down plants and equipment, and expand assets to improve service quality. When public sector monopolies are privatised, room is also created for new competitors, who also undertake new investment. That has been witnessed in the electricity, telecommunications and airline sectors. Privatisation also generates collateral investment (domestic and foreign) in supplier and ancillary industries. It results in spin-offs as privatised enterprises are unbundled to focus on core competencies and a climate is created to crowd-in private investment.

In addition to encouraging the acceleration of privatisation in those regions (e.g., South Asia and Africa) that lag behind other developing areas in that respect, MDBs and their affiliated investment corporations need to be more aggressive in co-financing FDI and FPI aimed at creating essential infrastructure that requires long gestation periods for project conceptualisation and development, for related tariff and regulatory arrangements to be negotiated and put in place, and for project construction. Financing such infrastructure used to be the forte of these institutions, although their experience was mainly with financing projects undertaken by governments and their public sector instrumentalities. In financing private entities to undertake the same type of projects, MDBs need to go beyond their basic long-term loan product. They need to consider taking up a significant share of the initial equity requirements as well as of project-related bond issues and convertible debt instruments. They need to go even further in providing policy risk and other types of comfort guarantees, and underwriting risk-management derivatives for new private projects.

For MDBs to play a more pro-active and diverse financing role on their own balance sheets would require their charters to be amended, but that would not be necessary, if they financed such projects through their affiliated investment corporations. However, the capital base for undertaking such financing on any significant scale throughout the de-

veloping world resides in the World Bank and the regional development banks, and not in their affiliated investment corporations. Moreover, for any new financial instruments and derivatives they might create to have credibility and to attract capable, creditworthy commercial counter-parties to accept the risks involved, the MDBs would need to put their own credit standing on the line. That fact makes it necessary to consider amending the Articles of Association of the MDBs which confine them (with the exception of the EBRD) to lending directly to governments or to entities with the backing of a government guarantee. That limitation is in urgent need of amendment for MDBs to respond to the new realities of private investors providing virtually all of the financing needed for physical investment in the developing world, especially for projects that permit cost-recovery and generate financial revenues. Most governments are wary of amending the Articles of MDBs, fearful of opening Pandora's Box in the process, but this irrational concern needs to be overcome. After all, the Articles of the IMF have been amended more than once, and the fall-out was contained.

None of this is fanciful generalisation. The financing needed to accommodate private financing of infrastructure and utilities has already been done in middle-income countries where initial political and public resistance was even stronger, as was scepticism about whether such solutions would work. It has been proven beyond any doubt that they can. Such transactions, repeated in HIPCs, could help reduce debt overhangs through swaps of official debt (held by bilateral and official multilateral agencies) for equity in public enterprises being privatised. However, for the generalisation (however practical) to become a reality, political will is required on the part of the developing countries concerned, and more imaginative management and vision in the MDBs/ICs, than has been displayed so far.

Regional Perspectives in Increasing FDI: As observed earlier, regional variations in FDI (*Tables 3 and 4*) are striking. Increasing FDI flows to Latin America, East Asia and Eastern Europe does not require much additional effort. Their doors to PCF have already been opened. The volume of FDI flowing to these three regions is determined more by market forces and the relative attractiveness of investment opportunities in their economies *vis à vis* opportunities in the industrial economies, and is not dependent on action by third parties to increase PCF.

But South Asia lags far behind any other region in the FDI stakes. The investment regimes of South Asian countries are being opened too slowly and reluctantly because of inertia in public administration, insufficiently widespread public support, and political reluctance to forego rent-extraction opportunities. Corruption, lack of transparency, and malfunctioning legal systems that do not settle commercial disputes and enforce property rights expeditiously, inhibit FDI flows to the sub-continent. PCF to South Asia could be increased very rapidly (and approach the FDI flows being attracted by China, which are ten times larger), if these constraints were removed.

To some extent, that is true for Africa as well, although greater progress has been made with improving investment regimes and policies than in South Asia. In Africa, FDI inflows are geared mainly to the hydrocarbon, mining, plantation and service (tourism, finance and transport) sectors, with insufficient FDI going to manufacturing. Although the traffic lights for FDI in Africa are being fixed under the pressure of adjustment, there is not as much FDI traffic as hoped. Foreign investors are deterred by internecine conflict, political instability, absence of communications infrastructure, and low standards of public administration. FDI in Africa, however, is also inhibited because most national markets are not viable in size. For FDI (or domestic private investment) to increase dramatically in that continent, sub-regional and regional market integration will need to accelerate.

The greatest challenges in attracting FDI (in areas other than tourism) are confronted by the small developing island states (SDIS) of the Caribbean, the Indian Ocean (Mauritius is an interesting exception) and the Pacific. These economies have relied on special and differential treatment (SDT) for a long time, but they have not yet been able to attract the kind of FDI that would enable them to diversify. Micro-markets, and the vast distances to be covered by sea and air, lead to prohibitive transport costs that deter private investment. The recent threat posed by the OECD's harmful tax competition initiative, aimed at curbing the operation of the offshore financial centres on which many island economies depend, will affect FDI adversely in these economies. It is not clear what will take the place of the offshore finance industry, if OECD countries succeed in achieving this misguided objective at the expense of these small countries with so few diversification options.

Belief in the need to maintain SDT preferences remains unshakeable in these SDIS, but tenaciously clinging to SDT may have retarded rather than promoted, development and diversification in these economies.²⁴ There is no

evidence to suggest that the time bought by SDT has been well used to secure the future by the SDIS, with the exception of Barbados, the Bahamas and Mauritius. The solution is probably for the SDIS to go for full economic integration with neighbouring trade blocs, under arrangements that would grant them free labour mobility as the *quid pro quo* for opening their investment regimes to investors in those blocs. To attract more foreign investment, SDIS (especially in the Pacific) should reconsider their reluctance to permit foreign investment in land and remove the restrictions on FDI they had imposed with the aim of protecting their indigenous ethnicity. These countries have to face the reality that a globalising world does not permit sovereign preferences to be exercised when sources of earnings are limited to very few opportunities (unlike the oil-rich countries of the Gulf and Brunei) and depend almost entirely on tourism and attracting FDI.

Encouraging FPI in Developing Countries

Involvement in promoting FDI inflows more pro-actively will open opportunities for MDBs to also expand FPI flows through two avenues: (a) guarantees for bond issues by sovereigns and sub-sovereigns in the developing world; and (b) bond and convertible debt issues as well as regional/ global equity placements by their instrumentalities that are being corporatised and privatised. The World Bank and regional MDBs should cease making direct non-concessional loans to middle-income and industrialised low-income countries. They should focus instead on introducing these countries to global bond markets by offering guarantees to facilitate market acceptability, lower borrowing costs and extend maturities. Their role between 2001-2010 should be to enhance market access rather than to keep these countries as direct borrowers as a means of protecting the quality of their loan portfolios.²⁵

24 See Page, S. and Hewitt, A. *World Commodity Prices: Still a Problem for Developing Countries?* (Overseas Development Institute; Special Report; ODI, London, 2001).

25 At present, most MDBs account for guarantees as if they were equivalent to loans for the purposes of meeting the prudential debt:equity ratio of 1:1 that is stipulated for most MDBs in their charters. There have been major internal arguments within these institutions, and between the management of these institutions and their more powerful shareholder treasuries, about whether such an equivalence is necessary, or whether it is a step toward over-prudence which inclines MDB managements to favour direct loans instead of guarantees. This issue needs to be revisited in all MDBs to ensure that guarantee powers are not artificially restricted or deliberately under-leveraged to meet management and staff preferences for making loans (which are more profitable) rather than issuing guarantees (which would result in less gross and net income for MDBs and, at the same time, require them to have less staff and lower administrative costs).

Going further, MDBs should encourage FPI by floating their own bonds in the domestic capital markets of countries where confidence is lacking in the sovereign issuer as a benchmark. The proceeds from such issues could be earmarked for spending on infrastructure (physical and social) in the same countries. The example of the European Bank for Reconstruction and Development (EBRD), which has floated bonds in borrowing member countries (e.g., Hungary) for financing local infrastructure is salutary; it needs further examination and selective emulation by other MDBs.

MDBs and the IMF could make a significant contribution to enhancing FPI flows to developing countries by offering guarantees for notes and bonds issued by the more creditworthy developing countries on international bond markets in US dollars, Euros and the Japanese Yen. Such guarantees should aim to make these instruments just as attractive and safe for developed and developing country central banks to hold as the treasury bonds issued in the US, European countries and Japan. MDBs already make special arrangements for selling their own paper to central banks by tailoring instruments to meet the specific reserve-holding requirements of the central banks of many developed and developing countries. They could quite easily do the same for bonds of the more creditworthy middle-income developing countries, especially those on the cusp of graduating from direct borrowing from the IFIs. If such actions could induce developing country central banks to hold 20% of their reserve holdings in such paper, rather than concentrating almost all of their holdings in developed country and MDB paper, it would result in shifting a stock of nearly US\$170 billion by way of bond market FPI to developing countries and assure an incremental flow of about US\$13 billion a year to developing countries, based on the averages experienced through the 1990s. If developed country central banks could be also induced to hold such paper to the extent of even 10% of their reserve portfolios, that would result in shifting a further stock of about US\$50 billion and annual FPI increments of a further US\$5-7 billion annually to the developing countries.

Every developing country now appears eager to attract FPI through accelerated development of its *national* capital market and especially its equity market. In most of these countries, such markets are neither efficient nor effective. They are too small, often listing only a few issues with limited market-making capacity and high operating, administrative and regulatory costs.

They lack economic size, depth, width and liquidity.²⁶ Markets such as these are likely to fail and to generate rather than solve resource mobilisation problems. If such markets succeed in attracting FPI, it is more likely to be harmful than productive. The urge to establish unviable national capital markets needs to be resisted. It should not be encouraged by the MDBs (particularly, the regional banks) as it appears to have been. With the advent of new communications and information technology in global financial markets, and with electronic exchanges replacing trading floors (thus making time, location and distance irrelevant in the processes of price discovery and matching trades), smaller countries (and MDBs) need to give more thought to creating *regional* capital markets. That option is likely to take them further in the development of their financial systems and to provide greater protective bulwarks, than attempting to go it on their own.

In middle-income developing countries (and some low-income countries), MDBs can go further by creating and making markets in derivative instruments that can be tailored or traded over-the-counter. Such instruments would allow private investors to hedge risks on either a long-term or rolling basis in developing country currencies and interest-rate movements.

To facilitate a greater volume of FPI flows to many more countries, without incurring the risk of repeated financial crises, the World Bank needs to transfer its traditional retail development financing activities to regional development banks and to focus almost exclusively (on a war footing) on improving financial systems and capital markets around the developing world.²⁷ There is an urgent need in most developing countries to

26 It is often argued that all developing countries need to have their own currencies and develop their own national capital markets to enjoy economic sovereignty and to have the instruments and policy flexibility needed to adjust to exogenous shocks and changes in comparative advantage as well as in relative competitiveness. There can be no serious opposition to such an argument in the case of most developing countries that have markets of a size to be self-sufficient and viable. These arguments, however, have been proven wrong in the case of smaller developing countries that are members of currency unions and have access to a single regional market within such a union. Although such countries are deprived of some policy tools (such as adjusting their exchange rates and interest rates) for economic management, they gain from the greater stability offered by regional arrangements that are appropriately designed and implemented.

27 Mistry, P. *Financing for Development* (2001). A Report commissioned by the Commonwealth Secretariat for the Meeting of Commonwealth Finance Ministers (St. Lucia, September 24-25, 2001). Commonwealth Secretariat, London.

deal quickly with chronic, endemic problems of non-performing assets in government-owned banking systems; privatising, rationalising and consolidating banks and non-bank financial intermediaries; creating more effective and efficient capital market institutions (i.e., merchant and investment banks, securities exchanges for debt, equity and derivative markets, brokerage firms, and regulatory institutions) that apply the same operational and regulatory standards as their global counterparts; and working with central banks and treasuries to improve their overall risk management practices on their external accounts. This task is more urgent than any other activity the Bank is undertaking. Rather than attempting to be all things to all people, its attention should be focused on playing a role that no other MDB can credibly play. The regional banks can, however, quite easily take over almost all of the other operational lending activities that the World Bank is engaged in.

Reprise of Observations and Suggestions for Enhancing PCF to Developing Countries

This paper has made several observations about evolving trends in PCF and suggestions about ways in which PCF to developing countries could be increased, and how it might make a more useful contribution to development by financing the capital investment necessary, as well as increasing the overall level of investment needed, to promote higher rates of growth. These observations and suggestions are adumbrated (seriatim) below for convenience of reference:

The Importance of PCF for Developing Countries and Its Impact:

- Trends in financial flows to developing countries established through the 1990s suggest that PCF will play a crucial role in financing physical investment in all developing countries with OCF playing a more limited role. For that reason ways need to be found for increasing all kinds of PCF (FDI as well as the various forms of FPI) to a wider universe of developing countries in the coming decades.
- Although the distribution of PCF across the developing world is alleged to be too concentrated and in some respects it is, it reflects the distribution of the developing world's "market capacity."

- Experience with PCF to developing countries suggests that their impact has been positive on domestic investment levels, but not necessarily on growth. Furthermore, their impact depends on the effect that PCF have on total factor productivity and on a country's capacity to
- absorb PCF efficiently and effectively. The impact of PCF weakens as a country's financial system integrates with global capital markets.

Distinctions between FDI and FPI:

- Distinctions between FDI and FPI concerning their relative productivity, volatility and desirability are often oversimplified and exaggerated in favour of FDI and can be misleading.
- Through derivatives, leverage and other financial engineering techniques, FDI can be made almost as liquid and mobile as FPI and can have the same destabilising effect at times of financial crisis. By the same token, some forms of FPI are associated with FDI and are just as fixed and stable.
- In practice, FDI and FPI are not always two distinct, separate and unrelated activities. With FDI now seeking to design a route to realise market value and reduce exposure risk as early as possible after the initial investment has been made, efficient secondary capital markets that attract FPI are also becoming an important influence in attracting FDI.

Foreign Direct Investment:

- FDI is now the single largest source of external financing for productive investment in developing countries, having grown from less than 0.15% of developing world GNP in 1980 and 0.80% in 1990 to 3% in 2001. FDI of US\$178 billion in 2000 dwarfed ODA (US\$55 billion) and was 12 times greater than the amount of development investment financed by ODA (US\$14 billion).
- FDI has been boosted by privatisation and by acquisition/merger activity, which is why it has remained concentrated in Latin America, East Asia and Eastern Europe throughout the 1990s, with South Asia and Africa accounting for about 5-10% of total FDI flows.
- Developing countries have made progress in improving the host climate for FDI. Although the volume of FDI has been responsive to these changes, the correlation between increased FDI and progress made in

improving the climate for it is not perfect. Corruption and lack of transparency have a statistically significant effect on deterring FDI flows.

- Contrary to expectations, the competitive pursuit of FDI as part of the process of globalisation has not resulted in a race to the bottom in compromising global labour or environmental standards. Instead, FDI has resulted in improving these standards in developing countries. In doing so, however, it has hollowed out the competitiveness of domestic firms.

Foreign Portfolio Investment:

- The volume of annual FPI flows (and especially of commercial bank lending) to developing countries has fluctuated considerably through the 1990s, particularly before and after financial crises. FPI flows respond quickly (and seemingly capriciously) to a variety of domestic and international factors and suffer from serious “imperfect information weaknesses” in nascent emerging markets.
- FPI in the form of bond and equity market flows is concentrated mainly in ten middle-income developing countries with relatively advanced capital markets (except in the case of China).
- The average annual increase in FPI across the developing world has been matched by a similar annual increase in international reserve holdings by developing country central banks.
- Bond market flows are heavily concentrated and go mainly to Latin America and Eastern Europe. These flows need to be spread more broadly, and a wider range of countries should be introduced to global bond markets in a phased manner with the support of the IFIs and MDBs.
- FPE flows are also concentrated in a handful of countries. In the long run, however, these flows are likely to represent the most stable and useful type of portfolio capital flows to developing countries because they have no fixed maturity date and thus carry no rollover risk.
- It is not completely clear what the net benefits of FPI have been for developing countries over the past decade. Nevertheless, FPI is still sought by countries because of the flexibility and liquidity it provides in the management of capital accounts without overt conditionality attached.
- FPI surges in fragile financial systems have proven to be explosive in the early stages of economic and financial market liberalisation. This nega-

tive effect calls into question earlier prescriptions about capital account opening at a stage in the reform process that has since proven to be premature.

- The lessons learned from the financial crises that occurred throughout the developing world in the 1990s suggest that FPI flows need better regulation and management at source and destination to avert contagion and mitigate the destabilising impact of herd behaviour on financial markets. Lessons have also been learned on how crises can be averted and better managed when they occur.

Financial Crisis Management:

- It may be premature to agree on an internationally co-ordinated global regime to govern the behaviour of FPI in developing countries. However, UNCFD should result in an agreement motivated by two aims: averting the recurrence of financial crises in the developing world and ensuring that the costs of adjustment are borne symmetrically by portfolio investors and banks as well as by developing countries. Achieving these aims will require fundamental changes in the approaches and instruments deployed by the IFIs in managing such crises.
- In the future, IFIs must organise bail-ins rather than bail-outs to stem capital outflows during a crisis; these should moderate portfolio investor behaviour in times of crisis by a requirement to purchase (at the time of entry) prophylactic derivative contracts tailored to discourage counterproductive speculation in currencies, interest rates or stock market indexes that might exaggerate and amplify a crisis. Enough is known about how this can be done in MDB treasuries and in developed country capital markets. Such knowledge needs to be transferred on a systematic and organised basis to the treasuries and central banks of developing countries, especially those receiving significant amounts of FPI.

Stimulating Increases in Private Capital Flows to Developing Countries:

- To provide a stronger “push effect” for PCF to developing countries, industrial donor countries should provide appropriately designed tax incentives and allowances *at source* both to the capital investment, and to income (repatriated profits and dividends) deriving from such investments, to private individuals and corporations investing in developing countries.

- Such tax incentives and allowances should be graduated on a sliding scale: the maximum tax benefits should be applied to private investment in the least developed and poorest countries, and such benefits should be scaled back progressively for investment in countries at higher income and development levels. To that end, agreement on uniform tax breaks to be applied across all donors should be reached by donors in the appropriate OECD-DAC forum.
- The total tax breaks provided by donor countries to their individual and corporate citizens should be counted as part of their “aid effort” in any future aid targets that are established and agreed to by the international community at UNCFD.
- Tax breaks offered by host-countries as a competitive tool for attracting FDI or FPI should be scaled down. Instead of using tax breaks to attract FDI and FPI, developing countries should compete in providing a more investor-friendly environment in terms of openness, transparency, lack of corruption, improved infrastructure and business support services, faster government decision-making for approvals, and the rationalisation of required procedures and formalities.
- FDI flows to developing countries should be enhanced through more imaginative and extensive sharing of various types of risk between private investors/operators and multilateral banks than is occurring at present. MDBs should go beyond providing limited sovereign risk insurance (e.g., through MIGA) and partial policy risk cover.
- Henceforth, MDBs should (a) take direct exposure in project development risk, construction risk, and full policy risk where tariff regulation by government is needed to assure cost-plus revenue recovery for utility projects; (b) take initial equity risk on large private projects or public-private partnerships with put options to place the equity with private operators and make public issues, when such risks become acceptable to operators and capital markets; (c) participate in long-term bond and convertible debt issues of privatizations and green-field long-gestating private infrastructure projects, and provide project construction bonds and risk cover to private contractors from developing countries.
- MDBs should provide total or partial (i.e., cash-flow strip) guarantees on principal, interest and/or principal and interest repayments that can be renewed annually for each year’s debt service payments on sovereign

and sub-sovereign bond issues on international capital markets, as well as bond issues related to specific infrastructure project undertakings (e.g., power plants, telecommunications networks, toll roads, tunnels, bridges, ports and airports). MDBs should also provide guarantees on structured bond placements by developing countries to the central bank reserve market.

- MDBs should, by 2005, cease making direct loans to middle-income and industrialised low-income countries and focus instead on introducing these countries to regional and international debt markets by offering guarantees tailored to facilitate market acceptance, lower borrowing costs and extend maturities.
- At least 65% of the number of investment operations (not volume of investments) of MDB private investment affiliates and departments should be concentrated in the least developed, low-income countries.
- MDBs (especially the World Bank) should undertake to provide assistance to developing country central banks and treasuries in designing and underwriting tailored, as well as over-the-counter, derivative contracts (i.e., futures, options, swaps on domestic interest rates, currencies, stock market indexes and on key liquid stocks that are included in such indexes) that can provide risk-hedging opportunities for private investors as well as for financial authorities (such as treasuries and central banks) in order to act as stabilisers and deter (through market operations rather than fiat) counter-productive speculation by private investors when financial crises appear imminent.
- Following the example of the EBRD, all MDBs should consider floating their own bonds in the local currencies of middle-income developing countries (where confidence in the sovereign as a benchmark issuer may be lacking) in order to accelerate the development of domestic debt markets and encourage FPI bond market inflows.
- In the HIPCs, the World Bank and RDBs should organise systematic debt-equity swap programmes involving their investment affiliates as well as bilateral investment agencies (e.g., CDC, KfW, FMO etc.) under which residual official debt (after write-down) can be exchanged for equity in utilities, banks, long-term financial institutions and industrial enterprises, which should, over the medium-term, be cleaned up and privatised.

- Such equity should be held by multilateral and bilateral investment agencies for an interim period while these enterprises are restructured and corporatised. As interim “owners” of such enterprises, these official investment agencies can bring in domestic and foreign private operators to improve the efficiency and viability of these former public undertakings. Eventually, such equity holdings should be relinquished to interested private operating partners and released on domestic, regional and (in appropriate instances) international capital markets.
- In small low-income countries, the World Bank and RDBs should shift their focus from encouraging the development of unviable small and illiquid national capital markets for equity and debt. Instead, they should encourage contiguous countries that have already entered into regional arrangements to create and develop more viable *regional capital markets* (particularly in Africa, South Asia, Central Asia, and in the Caribbean, the Indian and the Pacific oceans).
- Finally, a major realignment is necessary in restructuring the role of the World Bank *vis-à-vis* the regional development banks in order to support and accelerate private capital flows to the developing world. All retail lending and guarantee functions and operations of the World Bank should devolve to the relevant regional development bank in a particular developing region. These functions, which can easily be taken over by the RDBs, are a distraction for the World Bank and prevent it from playing a more focused and valuable role. Reacting to whimsically changing donor country or management preferences and staff compunctions rather than to genuine client country needs, the Bank is involved in a plethora of diverse unrelated activities that diminish its comparative advantage, under-utilise its resource mobilisation capacity, reduce its efficiency and effectiveness, bloat its administrative budget, and make it too diffuse and difficult to manage.
- The World Bank’s role over the next 25-50 years should be rationalised and limited to a wholesale role aimed at supporting the reform and development of financial systems, markets, institutions and financial regulatory authorities; accelerating the process of privatisation (especially of utilities, banks, financial institutions and large industrial enterprises) in all developing countries, but particularly in Africa and South Asia; and financing large-scale infrastructure projects with FDI and FPI participation.

Annex 1

The Distribution and Impact of Private Capital Flows in the Developing World

The Distribution of Private Capital Flows Across the Developing World: Private Capital Flows (PCF) play a major role in financing development in countries where physical and institutional infrastructure, markets, governance, and opportunities exist to absorb it productively, i.e., without bidding up asset prices and creating valuation bubbles. These conditions constrain its role in different parts of the developing world at different moments in time. While the nature of PCF constrain their reach, they are not intrinsically flawed because of that. On a *per capita* (rather than *per country*) basis PCF are reasonably distributed across the developing world, although the contrary is often implied. It is observed, for example, that 70-90% of PCF go to only 10-25 developing countries. That statistic disparages PCF as being too concentrated to matter to most developing countries. The implication is misleading. The 25 countries that absorb 90% of the PCF to the developing world, account for 75% of its population, 70% of its output, 80% of its trade and 80% of its international reserves. The concentration of PCF therefore reflects reasonably well the distribution of the developing world's "market capacity."

It would be odd to expect a different outcome. Eighty percent of private capital cannot flow to 80% of the number of developing countries. An island country with a population of fewer than 100,000 people, and no market to speak of, cannot absorb the same amount of private capital as India or China. There is a case for arguing that the distribution of private capital is skewed when Chile and Malaysia attract larger amounts of PCF than India or Nigeria; or when India gets less than 10% of the foreign direct investment (FDI) that goes to China. But the reasons for these distortions are not difficult to discern. They have little to do with inherent flaws in PCF. They have more to do with fundamental structural and policy weaknesses in destination countries and in their political preferences. Similarly, it is not the fault of foreign portfolio investment (FPI) that it gravitates towards better developed emerging markets that have the capacity to absorb it.

What needs to be done to widen and deepen the cross-country distribution of PCF has been explicated at length in pertinent literature, in the exhortations of the IFIs, in: (a) the *Report of the Secretary-General to the Preparatory Committee for the International Conference on Financing for Development* – referred to as the Secretary-General’s Report (SGR) and (b) the *Technical Report of the High-Level Panel on Financing for Development* – referred to as the Zedillo Panel Report (ZPR). What is not so obvious (as SGR and ZPR imply) is that conscious or inadvertent policy choices, which deter PCF from entering many developing countries, should result automatically in the consequent FfD gap being filled by equivalent amounts of ODA.

PCF are not a substitute for OCF although PCF play a significant role in affecting the lives of over 80% of the people in the developing world. PCF are not yet as important in the least developed countries (LDCs), although the potential even there (e.g., in Bangladesh²⁸) is greater than generally recognised. LDCs (and HIPC in particular) will depend on ODA flows for some time to come. Their financial systems are too nascent to attract FPI, although many LDCs offer significant opportunities for FDI. In some, an unsustainable debt overhang deters private flows, as do their level of development, the structure of their economies, the absence of opportunities and infrastructure, and their lack of natural resources. In short, their financing needs do not match the preferences of private capital. For those reasons, PCF and OCF (especially their ODA component) are not perfect substitutes. However, experience suggests that PCF can replace OCF more widely, deeply and to better effect in a number of areas.

The Impact of Private Capital Flows on Development

The Impact of PCF in Theory: Economic theory suggests that *global* efficiency and welfare gains are derived when capital flows from high-income (capital surplus) countries to low-income (capital deficient) countries, where the marginal productivity of investment is higher.²⁹ Market theory favours unrestricted capital flows for three other reasons: (i) unrestricted global movements of capital permit its owners to reduce risk by allowing wide

28 FDI inflows to Bangladesh jumped from US\$14 million in 1996 to over US\$180 million in 1999. Even then they amounted to only 0.4% of the country’s GDP (see GDF-2001, Box 2.2, pg. 39).

29 Summers, L. “International Financial Crises: Causes, Prevention and Cures,” 2000, *American Economic Review Papers and Proceedings* 90 (2), pp. 1-16.

portfolio diversification; (ii) global integration of capital markets leads to global diffusion of best practices in corporate governance and regulation; and (iii) global capital mobility restrains governments from pursuing poor economic and financial policies.³⁰ The theory of the firm suggests that the impact of PCF on domestic investment might be ambiguous.³¹ FDI by multinationals may induce domestic firms to reduce investment in the same industry. In a world of complete capital mobility, an increase in foreign capital inflows may have no impact on the level of domestic investment; i.e., PCF would finance existing demand for investment by firms rather than increasing that level of demand. PCF can increase imports and dampen domestic output and investment. FPI (especially if induced by global competition among financial firms, or by tax avoidance, evasion or reduction motives) may trigger sudden large outflows when policy risks materialise.

The Empirical Evidence: Experience between 1980-2000 has resulted in a re-evaluation of the implications of PCF for development and their effect on the growth dynamic. Recently conducted econometric studies³² reached five main conclusions:

- *First*, PCF have a positive impact on domestic investment but not always on growth.³³ That effect applies across developing regions and over time.

30 Feldstein M. "Aspects of Global Economic Integration," NBER Working Paper No. 7899 (2000). National Bureau of Economic Research, Cambridge, Mass., USA.

31 Feldstein M. "The Effects of Outbound Foreign Direct Investment on the Capital Stock," NBER Working Paper No. 4668. National Bureau of Economic research, Cambridge, Mass., USA.

32 Several of these have been reviewed in *Global Development Finance –2001; Volume 1 – Building Coalitions for Effective Development Finance: Analysis & Summary Tables*; World Bank, Washington, DC. [Chapter 3, "International Capital Flows and Economic Growth," pp. 59-83].

33 Empirical evidence on the link between PCF and growth is confusing. Average growth across the developing world has been stable and low in the 1990s when PCF mushroomed. The middle-income countries that received the largest proportion of PCF did grow faster than those that did not, but so did countries like India, which received less PCF than the size of its economy might have suggested, yet managed to be among the 10 fastest growing developing countries. Attempts to find a link between (a) capital account liberalisation and growth, e.g., (1) Rodrik, D. "Who Needs Capital Account Convertibility?" (1998) in Fischer, S. et al. (eds.) *Should the IMF Pursue Capital Account Convertibility? Essays in International Finance*, 207, Dept. of Economics, Princeton University, Princeton, NJ, USA; and (2) Grilli, V. and Milesi-Ferretti, G-M. "Economic Effects and Structural Determinants of Capital Controls" (1995) IMF Staff Papers 42, IMF, Washington, DC., and (b) FDI and growth, e.g., Carkovic, M. and Levine, R. "Does Foreign Direct Investment Accelerate Economic Growth," University of Minnesota 2000 (draft mimeo), did not uncover a strong link in either case. The World Bank offers two reasons for this (GDF-2001, Box 3.1, p. 67): (i) the high volatility of PCF may negate its impact; and (ii) poor absorptive capacity may vitiate the effectiveness of FDI. On this issue see also Mishra, D., Mody, A. and Murshid, A.P., "Private Capital Flows and Growth?" in *Finance and Development*, June 2001, IMF, Washington, DC.

The impact on investment is strongest in low-income countries and regions (e.g., Africa) where FDI in natural resource exploitation is the predominant component of PCF.

- *Second*, the extent of the impact of PCF on investment (and on growth) depends on a country's capacity to absorb and utilise it effectively. Absorptive capacity is multifaceted. It embraces the quality and stability of a country's macroeconomic policy regime, political regime, governance, financial system, human, social and institutional capital, physical infrastructure and public services, and, conversely, the level of corruption. Differences in absorptive capacity explain why PCF in general, and FDI in particular, have a greater impact on development in some countries than in others.
- *Third*, to the extent that poor investment climates (i.e., low absorptive capacity) are associated with low-incomes, PCF may have contributed to the diverging economic performance across developing countries in the 1990s. Low-income countries (except India) grew more slowly in the 1990s than middle-income countries. Faster growth and higher levels of investment (as well as greater absorptive capacity) attracted more PCF to middle-income countries, thus reinforcing a "high resource flow – high growth" dynamic that has eluded low-income countries. The HIPCs have also been saddled by debt burdens that restrained their growth.
- *Fourth*, as closer integration occurs between a developing country's financial system and global capital markets, the impact of PCF on domestic investment weakens, although PCF still have a positive impact on productivity.³⁴ The link between PCF and domestic investment is weakened because countries use PCF to finance current account deficits and accrue reserves, or because PCF finance domestic capital flight.
- *Fifth*, PCF may not impel growth, even when they finance additional investment, unless they have a positive influence on increasing total factor productivity.³⁵

Examined by the specific type of PCF concerned, the dangers of *commercial bank lending* (especially short-term lending) as a source of FfD be-

34 This happens when FDI or FPI finance mergers and acquisitions (e.g., in East Asia and Latin America in 1998-2000).

35 *GDF-2001*, World Bank, op. cit., Chapter 3, "International Capital Flows and Economic Growth," pp. 70-76; and Mishra, D., Mody, A. and Murshid, A.P., op. cit.

came clear in the debt crisis of 1982-89. Yet history repeated itself when somewhat similar dangers materialised in 1994-95 and 1997-98. In the 1980s, medium-term syndicated lending to sovereign governments, coupled with excessive short-term borrowing, was at the heart of the crisis. In the 1990s, it was the impact of short-term foreign currency borrowings by domestic and foreign corporations, responding to conflicting domestic interest and exchange rate signals, that was largely to blame. The conclusion to be drawn from these experiences is not that foreign commercial bank borrowing should be shunned by developing countries. That would freeze their working capital and trade financing requirements, which are lubricated by such borrowing, and inhibit the growth of FDI and intra-firm trade. The lesson is to avoid policies and practices that provide incentives for the misuse of bank borrowing, and/or use that alternative as a soft option for avoiding difficult political and policy choices that are needed to bolster domestic resource mobilisation.

FDI has benefits in contributing to increasing the level and quality of investment, of productivity and in terms of the associated know-how transfer of both hard and soft (i.e., management) technology.³⁶ In low-income countries, FDI supplements inadequate domestic savings while identifying and realising a range of investment opportunities more effectively than domestic firms can. Regionally, the strongest correlation between PCF and domestic investment is in Africa, which receives most of its PCF in the form of FDI, as compared to East Asia or Latin America, which receive a large proportion of FDI. The poorest countries and regions, however, receive limited amounts of FDI, which is often concentrated on the exploitation of natural resources. Although its virtues are extolled, FDI is not costless. It creates long-term liabilities when dividends are remitted and interest is repaid to parent companies, and when invested capital or

36 Chapter 2 of *Global Development Finance 2001*, op. cit., reviews a number of studies that attempt to ascertain the impact of foreign capital flows on domestic investment. Two recent studies find a strong impact of foreign capital (particularly FDI) on domestic investment although some part of the inflow is offset by outflows and the accretion of reserves (See Borensztein, E., De Gregorio, J. and Lee, J.-W. "How Does Foreign Direct Investment Affect Growth?" 1998, *Journal of International Economics*, 45 (1): pp. 115-35; and Bosworth, B. and Collins, S. "Capital Flows to Developing Economies: Implications for Saving and Investment," 1999 *Brookings Papers on Economic Activity* 1: pp. 143-69.) Foreign capital inflows appear to be associated with broadly based stimulation of domestic demand. (Loungani, P. and Razin, A. "How Beneficial is Foreign Direct Investment for Developing Countries?" in *Finance and Development*, June 2001, IMF Washington, DC.)

borrowings from the parent company are repatriated. These future charges on income are affordable, if FDI creates wealth, generates income and averts immediate debt service burdens. The liabilities FDI creates become onerous only when the assets it finances fail to generate the returns that were anticipated at the time of investment.

FPI has the benefit of providing external liquidity, thereby boosting reserves and money supply in the short-run. If it is in the form of equity or market-tradable debt (i.e., bonds), FPI enables countries to diminish their reliance on commercial bank borrowings and on OCF/ODA for boosting their international reserve holdings and providing them with greater flexibility in managing their external accounts. On the other hand, FPI is inherently volatile.³⁷ Because it is liquid, it can exit suddenly as well as encourage domestic capital flight. Without astute management by monetary and fiscal authorities to control or dampen the impact of inward surges, FPI can lead to financial de-stabilisation and trigger swift outflows with knock-on effects that impair growth and risk structural damage in the real economy.

³⁷ *GDF-2001* World Bank op. cit., Chapter 3, "International Capital Flows and Economic Growth."

Annex 2

Recommendations of the UN Secretary-General's Report (SGR) to the Preparatory Committee for the International Conference on Financing for Development on Mobilising Foreign Direct Investment and Other Private Flows

In Chapter II, the SGR makes the following fourteen observations and recommendations on increasing PCF to developing countries:

- Host developing countries and countries with economies in transition that seek to attract long-term international investment flows should continue to take steps to put into place a transparent, stable and predictable framework for private investment and the institutional infrastructure that allows its efficient implementation. Such a framework and the related infrastructure encourages not only international but also, just as importantly, domestic investment.
- An inventory of home country measures to enhance FDI outflows to developing countries should be established. Developed countries should emulate best practices regarding such measures and should devise additional measures to encourage and facilitate investment flows to developing countries, especially LDCs and other low-income countries.
- Member states should consider the convening of *ad hoc* global hearings to discuss the issues surrounding international investment agreements and, in particular, the extent to which such agreements can further the development of developing countries. Such a dialogue should involve governments, the private sector and civil society.
- The Conference (i.e., UNCFD) should encourage relevant international organisations to undertake a deeper examination of issues related to corporate governance and, in particular, their relevance to developing and transition economy countries, taking into account their specific legal, social and cultural environment. In particular, support should be given to efforts to develop and implement international accounting, reporting and auditing standards, taking the needs of these countries into account.
- The relevant international organisations and donor countries, in cooperation with the potential recipient countries and with firms and private

sector associations, should expand and facilitate information flows on investment opportunities in developing countries, particularly LDCs and African countries. At the same time, international institutions involved in supporting FDI flows should evaluate the development impact of investment flows in recipient countries, including social development concerns.

- Countries should examine critical infrastructure constraints for private sector development. Priorities should be identified for the involvement of the private sector in the financing of infrastructure projects, including those in areas, such as telecommunications, that help to bridge the digital divide. Private-public sector commercial partnerships (e.g., co-financing, partial or full risk guarantees, and technical assistance and advisory services) may also offer opportunities in support of the above. In cases in which host countries provide incentives to encourage private sector financing, guarantees should be fully identified, appropriately classified, and monitored so they do not hide contingent fiscal risks that could threaten fiscal stability.
- The Conference should propose the establishment of an expert group to examine ways and means through which FDI flows among developing countries can be further encouraged. Attention should be given to “growth triangles” especially those comprising geographically proximate areas, and to the role of regional investment frameworks in facilitating intra-regional division of labour and helping attract FDI.
- Host and home countries, as well as TNCs and international organisations, should compile an inventory of best practices through which more and deeper linkages between foreign affiliates and local enterprises can be encouraged, with a view to helping foster a vibrant domestic enterprise sector in developing countries; in particular, this inventory should contain successful practices to transfer and disseminate technology, as well as to build local R&D capacities. TNCs should emulate such best practices to the largest extent possible. Likewise, options should be devised through which existing commitments in international agreements to encourage the transfer of technology can be operationalized.
- Greater international cooperation among national competition authorities is necessary and should be encouraged. Special attention should be given to work aimed at strengthening international cooperation on competition policy and regulation, in particular as regards M&As, with a view to promoting a greater understanding of the issues involved, especially in developing countries, and to increasing cooperation in imple-

mentation among all the countries concerned. Merger review guidelines have a role to play in this context, by increasing transparency and reducing differences in the technical criteria used.

- TNCs and other firms should accept and implement the principle of good corporate citizenship and should *inter alia* subscribe fully to the UN Global Compact. Global Compact participants should take specific measures that foster development – including innovative partnerships, linkages and collective action – and share their experience with all stakeholders.
- Credit rating agencies should endeavour to rate sovereign risk according to criteria that are as objective and publicly known as possible. Borrowing developing and transition economy countries should give priority to the development of reliable local systems of credit information in accordance with international practices and in close cooperation with international rating agencies.
- Governments and international organisations should implement measures to strengthen the transparency of financial markets; furthermore, the relevant authorities, in their review of the impact of the activities of highly leveraged international investors on the stability of national banking systems, should propose ways in which the risks associated with this impact can be taken into account in revising the existing capital adequacy standards for banks.
- The recent initiatives in the UN General Assembly and the Bretton Woods Institutions in the fight against money laundering should be pursued, and member states should continue to strengthen measures against illicit transfer of funds and improve the exchange of information across borders; encourage additional measures by large international banks; and enhance international cooperation with a view to reaching a common approach for combating money laundering and financial crime.
- The Conference should consider setting up an *ad hoc* forum to bring together representatives of governments, international organisations, business, labour and NGOs in order to facilitate a dialogue on policy and technical assistance issues relating to FDI. The objective should be to facilitate such flows to developing countries, especially the LDCs, to identify obstacles and to examine best practices in regard to government policies for maximising the contribution of FDI to development and minimising any negative effects.

Table 1:

Net Resource Flows to All Developing Countries (1970-2000)

(in US\$ billions)

	1970	1980	1991	1995	1996
Total Net Resource Flow	11.3	82.8	119.9	233.1	274.3
Official	5.6	34.9	60.9	55.1	31.9
Private	5.7	47.9	59.0	178.0	242.4
<i>FDI</i>	2.2	4.4	35.7	107.0	131.5
<i>FPI + Bank Lending</i>	3.5	43.5	23.3	71.0	112.3
FPI	0.2	1.2	15.5	38.8	76.2
Equity	0.0	0.1	4.6	8.0	13.7
Bonds	0.2	1.1	10.9	30.8	62.5
Bank Lending	3.3	42.3	5.0	30.5	33.7
Other	0.0	0.0	2.8	1.7	2.4
Interest Payments on Debt	-4.1	-48.9	-72.3	-98.6	-104.5
Remittances on FDI	-6.5	-23.7	-18.3	-26.5	-30.4
Net Transfers	0.7	10.2	29.3	108.0	139.4
Official	4.7	28.8	41.1	22.8	1.2
Private	-4.0	-18.6	-11.8	85.2	138.2

Table 2:

Composition of Net Resource Flows between 1972-98 to Developing Countries by Region (as a percentage of total net resource flows from all sources)

	Total	EAP	LAC	ECA
Sources of Funding				
Total Net Resource Flows	100	100	100	100
<i>Short-Term</i>	11	13	8	6
<i>Long-Term</i>	89	87	92	94
Official Flows	34	27	22	39
Private Flows	55	60	70	55
<i>FDI</i>	20	31	29	15
<i>FPI (D+E)</i>	8	10	8	10
<i>Bank Loans</i>	20	15	28	22
<i>Other</i>	7	4	5	8
Uses of Funds				
Net External Finance	54	45	66	67
Financing Current a/c Deficit	34	22	47	66
Increase in Reserves	20	23	19	1
Capital Outflow				
+ Errors/Omissions	46	55	34	33

Source: World Bank: Global Development Finance (GDF) 2001

	1997	1998	1999	2000
Total Net Resource Flow	334.6	327.9	250.7	283.5
Official	42.8	54.6	45.3	38.6
Private	291.8	273.3	205.4	244.9
<i>FDI</i>	172.6	176.8	185.4	178.0
<i>FPI + Bank Lending</i>	119.2	96.5	20.3	66.9
FPI	71.4	49.5	46.5	65.9
<i>Equity</i>	22.4	8.6	21.1	34.8
<i>Bonds</i>	49.0	40.9	25.4	31.1
Bank Lending	45.1	50.0	-24.6	0.7
Other	2.7	-3.0	-1.6	0.3
Interest Payments on Debt	-109.1	-122.6	-122.7	-133.6
Remittances on FDI	-31.4	-35.2	-40.0	-50.2
Net Transfers	194.1	170.1	88.0	99.7
Official	10.3	19.2	-10.2	-24.0
Private	183.8	150.9	98.2	123.7

Source: World Bank: GDF-2001

	SAS	SSA	MENA
Sources of Funding			
Total Net Resource Flows	100	100	100
<i>Short-Term</i>	2	10	11
<i>Long-Term</i>	98	90	89
Official Flows	69	63	47
Private Flows	29	27	42
<i>FDI</i>	9	15	15
<i>FPI (D+E)</i>	9	2	9
<i>Bank Loans</i>	10	4	6
<i>Other</i>	1	6	12
Uses of Funds			
Net External Finance	74	68	25
Financing Current a/c Deficit	65	67	-27
Increase in Reserves	9	1	52
Capital Outflow			
+ Errors/Omissions	26	32	75

Table 3:

Net Private Capital Flows in the Context of ODA Flows, External Debt and Debt Service – 1999

(Amounts in US\$ billions, GNP in US\$ trillions, and last two columns in percent)

	PCF US\$bn	FDI US\$bn	XDT US\$bn	XDS US\$bn	GNP US\$Tn
All Developing Countries,					
<i>of which</i>	205.4	185.4	2,564.0	389.3	6.33
Low Income Countries	2.1	9.8	572.0	47.2	0.94
Middle Income Countries	203.3	175.6	1,992.0	342.1	5.39
East Asia and Pacific	51.0	56.0	675.0	111.7	1.85
South Asia	2.2	3.1	165.0	14.6	0.58
Eastern Europe and Central Asia	41.1	26.5	486.0	60.9	1.06
Middle East and North Africa	1.1	1.5	209.0	25.6	0.60
Sub-Saharan Africa	10.4	7.9	216.0	14.3	0.30
Latin America and the Caribbean	99.6	90.4	813.0	162.3	1.94

Table 4:

Foreign Direct Investment in the Developing World

	1970	1980	1991	1992	1993	1994
FDI (in US\$ billions)						
All Countries	60	93	160	172	226	256
Developing Countries	2	4	36	47	67	90
Developing Countries' FDI Share (in percent of total)	2.9	4.30	22.3	27.4	29.5	35.2
NFDI ratio to GNP (in percent)						
For All Developing Countries	0.25	0.14	0.78	1.03	1.43	1.75
East Asia and Pacific	0.20	0.30	1.43	2.03	3.32	3.20
South Asia	0.08	0.08	0.10	0.20	0.29	0.37
Eastern Europe and Central Asia	0.01	0.01	0.31	0.46	0.66	0.84
Middle East and North Africa	0.71	0.86	0.38	0.49	0.83	0.74
Sub-Saharan Africa	0.16	0.02	0.33	0.56	0.71	1.28
Latin America and the Caribbean	0.68	0.82	0.68	0.75	1.04	1.83

Source: World Bank: Global Development Finance (GDF) 2001

Official Development Assistance

	Amt. US\$bn	ODA/pc US\$	LGNIODA/GDI %	GDI %
All Developing Countries,				
<i>of which</i>	40.3	8.0	0.6	0.84
Low Income Countries	19.3	7.0	1.9	3.15
Middle Income Countries	21.0	12.0	0.4	0.48
East Asia and Pacific	8.1	5.0	0.4	0.37
South Asia	3.9	3.0	0.7	1.20
Eastern Europe and Central Asia	9.2	21.0	0.9	1.35
Middle East and North Africa	3.8	16.0	0.6	1.25
Sub-Saharan Africa	11.2	20.0	3.7	7.65
Latin America and the Caribbean	4.1	10.0	0.2	0.30

Note:

PCF= Net Private Capital Flows; **FDI**= Net Foreign Direct Investment

XDT= Total External Debt Outstanding; **XDS**= External Debt Service for that Year

IODA=Investment-related ODA; **LGNP**=GNP of Developing Countries

ODA/pc= ODA per capita

Source: World Bank: GDF 2000 and 2001

	1995	1996	1997	1998	1999	2000
FDI (in US\$ billions)						
All Countries	331	377	473	683	982	1,118
Developing Countries	107	132	173	177	185	178
Developing Countries' FDI Share (in percent of total)	32.3	34.9	36.5	25.9	18.9	15.9
NFDI ratio to GNP (in percent)						
For All Developing Countries	1.90	2.11	2.67	2.95	2.93	2.63
East Asia and Pacific	3.01	3.09	3.32	3.84	3.02	2.86
South Asia	0.62	0.69	0.91	0.64	0.53	0.51
Eastern Europe and Central Asia	1.76	1.47	2.12	2.52	2.51	2.76
Middle East and North Africa	0.08	0.41	0.87	1.14	0.24	0.69
Sub-Saharan Africa	1.53	1.66	2.54	2.05	2.59	2.36
Latin America and the Caribbean	1.82	2.44	3.35	3.71	4.64	3.62

Table 5:

Proportions of FDI Flows to Middle Income, Low Income and Least Developed Countries (in percent)

	1991	1992	1993	1994	1995
FDI to All Developing Countries					
Middle Income	87.3	89.3	89.1	90.0	87.0
Low Income	12.7	10.7	10.9	10.0	13.0
FDI as percent of GDP					
Middle Income	0.9	1.1	1.5	1.9	1.9
Low Income	0.5	0.6	0.9	1.0	1.4
FDI flows to 47 LDCs					
As of total FDI	5.0	3.1	2.6	1.0	1.8
As of GDP	1.4	1.3	1.5	0.8	1.6

Table 6:

Foreign Portfolio Investment Flows from Capital Markets to Developing Countries 1991-2000 (in US\$ billions)

		1991	1992	1993	1994	1995
Total	Gross	79.9	88.2	158.9	153.7	201.4
	Net	23.3	44.1	57.3	67.5	71.0
Bonds	Gross	11.0	20.1	50.1	45.7	52.6
	Net	10.9	11.1	36.6	38.2	30.8
Banks	Gross	61.3	54.0	57.5	72.8	112.7
	Net	5.0	16.2	3.4	8.7	30.5
Equity	Gross	7.6	14.1	51.0	35.2	36.1
	Net	4.6	6.0	8.1	17.0	8.0
Other	Net	2.8	10.8	9.2	3.6	1.7

Source: World Bank: GDF – 2001.

	1996	1997	1998	1999	2000
FDI to All Developing Countries					
Middle Income	86.5	88.8	92.4	94.7	93.2
Low Income	13.5	11.2	7.6	5.3	6.8
FDI as percent of GDP					
Middle Income	2.1	2.7	3.1	3.2	2.8
Low Income	1.7	1.8	1.4	0.9	1.1
FDI flows to 47 LDCs					
As of total FDI	1.9	1.5	2.0	2.7	2.5
As of GDP	1.8	1.7	2.4	3.3	2.8

Source: World Bank: GDF – 2001, tables 2.2 and 2.6.

		1996	1997	1998	1999	2000
Total	Gross	272.0	323.6	196.4	198.8	249.5
	Net	112.3	119.2	96.5	20.3	66.9
Bonds	Gross	97.6	114.3	73.0	70.3	77.2
	Net	62.5	49.0	40.9	25.4	31.1
Banks	Gross	125.2	179.1	107.8	94.0	124.4
	Net	33.7	45.1	50.0	-24.6	0.7
Equity	Gross	49.2	30.2	15.6	34.5	47.9
	Net	13.7	22.4	8.6	21.1	34.8
Other	Net	2.4	2.7	-3.0	-1.6	0.3

Schemes for Resolving the Sovereign External Debt Problem

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Abstract

Removing crushing debts is a precondition for any successful development policy. The various debt reduction schemes dictated by creditors, however, have failed to achieve that aim. The evolution of over-indebtedness and the effects of insufficient reductions are illustrated numerically to show the shortcomings of debt management. Historical examples, particularly those of Germany in 1953, or Egypt in 1876, prove that solutions were more efficient and debtor-friendly before BWI-led debt management began. By granting too little too late, absolute, dominant creditors have caused further damage to debtor economies by leaving them either over-indebted, or with such high debts that further crises were facilitated. The necessity and feasibility of a Fair Transparent Arbitration Process (FTAP) modeled on domestic insolvency for debtors with governmental powers (US Chapter 9), and its immediate applicability to sovereign debtors are shown. In essence, it contains both one of the most fundamental features of the Rule of Law: impartiality (not being allowed to judge one's own case), and debtor protection. Civilized legal systems do not permit debtors to be forced to starve their children in order to be able to pay more. This human right overrides the sanctity of contracts – except in the case of over-indebted developing countries. Arbitration based on these principles can provide an economically efficient and humane solution. The Rule of Law and this basic human right should not be denied any longer to any human being. Arbitration must replace arbitrariness.

Introduction

It is clear that many sovereign debtors are unable to repay their debts fully. Creditors recognized this fact long ago and eventually offered various debt reduction schemes. Nevertheless, the problem has dragged on, obstructing development. Insufficient debt reduction continues to burden debtor economies. This is especially evident in the case of the heavily indebted poor countries (HIPCs). The official objective of the first HIPC Initiative was to achieve overall debt sustainability through coordinated action that would enable such countries to get out of continuous debt re-scheduling (IBRD 1997, p. 44). The very existence of HIPC II, however, proves that HIPC I failed to fulfill that objective. James Wolfensohn's efforts are indeed laudable, but although HIPC I was a welcome step in the right direction, it did not go far enough, and this is also a shortcoming of HIPC II. The problem is possibly less visible in the case of middle-income countries, where high debt stocks remain the underlying cause of crises that would not occur if debt reductions were sufficient.

This paper starts with a simple illustration of the evolution and effects of over-indebtedness. Historical examples are then compared with present strategies. Finally, the idea of a Fair Transparent Arbitration Process (FTAP) on debts is discussed, a "debt arbitration process to balance the interests of creditors and sovereign debtors and introduce greater discipline into their relations" (Annan 2000, p. 38).

The Nature of Debt Overhang

Over-indebtedness, which is often referred to as *debt overhang*, describes a situation in which parts of the debt stock are unpayable. This situation can be illustrated by a simple numerical example where a debtor has 5% interest, no amortization, and an initial debt stock of US\$1,000. Of course, the example could be made more complicated, e.g., by introducing amortization, variable interest rates, or inflation. Doing this would make the example harder to understand, but it would not change the basic mechanism that is at work here. Capitalized arrears increase debt stocks, as anyone familiar with basic mathematics can verify.

During Year 1, the debts grew by capitalized arrears of US\$25. As our debtor is insolvent and not (temporarily) illiquid, the problem does not disappear. Debts accumulate. By the end of Year 10, the debt stock has reached

US\$1,279 (US\$1,247 + US\$32). The gaps between the debt service due and what has actually been paid widen, although debt service increases steadily, possibly because of the “lemon squeezer effect” of BWI-type “structural adjustment.” Debts accumulate on the creditors’ books, and the share of what may be called “phantom debts” increases. These phantom debts exist on paper, but are economically non-existent: they cannot be cashed in and are technically irrecoverable.

Table 1:
The Evolution of Unpayable Debts

	Debt Stock	Debt Service Due	Debt Service Paid	New Debt
Year 1	1,000	50.00	25.00	25
Year 2	1,025	51.25	26.25	25
Year 3	1,050	52.50	26.50	26
Year 4	1,076	53.80	27.80	26
Year 5	1,102	55.10	28.10	27
Year 6	1,129	56.45	28.45	28
Year 7	1,157	57.85	28.85	29
Year 8	1,186	59.30	29.30	30
Year 9	1,216	60.80	29.80	31
Year 10	1,247	62.35	30.35	32

Because creditors are unwilling to grant the necessary debt reductions in time, debts are boosted to ever higher and more unrealistic levels. Debt reduction to sustainable levels appears more and more costly – on paper. Cancelling US\$520 after two years would have allowed the debtor to pay as due – if at least the income level (or for sovereign debtors, the level of expected foreign exchange earnings) had been upheld that year. This situation is by no means certain if protracted debt service has already absorbed the capital needed for renewal and re-investment. When this happens, production capacities are reduced in the long run, as the IBRD or

the GATT predicted already in the 1980s. Finally, US\$672 must be cancelled (new stock: US\$607) to allow all obligations to be honored with US\$30.35. The difference (US\$152) – pure phantom debts that were created when arrears accumulated on top of already unpayable debts – is the result of the creditors' opposition to a timely reduction.

Some interesting conclusions emerge from this simple example:

1. Deleting phantom debts simply acknowledges facts. Since you can't lose money you can't get anyway, deleting phantom debts doesn't really cost creditors anything. It is "generosity for free." Debtors get no real relief. The costs of debt relief are exaggerated by including phantom costs at face value. An example of this is provided by the US\$34 billion that have accumulated over time – an amount equal to two-thirds of HIPC's total costs – according to official estimates for 22 decision-point HIPCs.
2. A meaningful reduction must go beyond simply removing phantom debts. If the debtor's future – in US legal parlance: his "fresh start" – is put at risk, a certain share of the remaining claims can also be paid. In any normal insolvency case, however, more than US\$152 would be cancelled to protect the debtor and to ensure his economic sustainability. Investments needed to ensure financial viability and the "tools of trade" are exempt. Debtors are also guaranteed a minimum standard of living. Reductions that are too small – "Highly Insufficient Payments Cuts" (HIPCs) – expose debtors to relatively small external shocks and are likely to impair their capacity for honoring their remaining obligations. Furthermore, rational private investors will be reluctant to invest, fearing the next "adjustment" program, and nationals will have an incentive to transfer assets out of their own countries. High real interest rates may also have the effect of attracting highly speculative, extremely short-term capital that is motivated by the prospect of making a quick buck within a few days before leaving again. This is particularly the case when speculators can expect to be protected by official bail-outs that socialize losses. Such inflows, however, are a far cry from the capital needed to finance development, and are likely to aggravate rather than to defuse a crisis.

3. Reductions that are too small, barely sufficient, or conditional on the debtor's making additional expenditures, produce, quite logically, new crises since further loans are then needed to finance debt relief. The interest rate on the additional loans is immaterial – even 0.5% is not feasible. If US\$160 are cancelled (US\$8 more than the US\$152 we called “pure phantom debts”), and the debtor's financing measures (e.g., poverty reduction) amount to US\$16, the debtor must now finance these measures with new loans. New arrears accumulate, even if no external shocks occur. An increase of 8¢ (eight cents) *per annum* (US\$16 at 0.5% interest) is moderate. The arbitrarily assumed 10% swap for poverty reduction is low, but the circular causation of arrears starts again. This time, however, it evolves relatively slowly because the additional borrowing is highly concessional. The Zedillo Report (p. 61) was probably aware of this problem when it demanded softer IDA-terms (99-year maturity and a 40-year grace period).

Poverty reduction and the investments necessary for sustainability must be financed from debt reductions of over US\$672 – money the creditors could technically collect even without debtor protection. Additional financing must obey the restriction

$$\text{Additional Financing} \leq (\text{Total Reduction}) - 672 \quad (1)$$

If the equal signs apply, the debtor will continue to be exposed to minimal shocks and the risk of being unable to maintain perceptibly increased payments (US\$30.35). Insufficient cancellations create vulnerability. If HIPCs pay more after “relief” than before, other expenditures will be crowded out by increased debt service.

4. By delaying relief, the creditors damaged the debtors, and made things more difficult for themselves. A substantial share of the present debt was caused by creditors that delayed the necessary reductions for years. The IBRD (1997, p. 42) has acknowledged that

[t]he surge in borrowing, coupled with increasing reliance on rescheduling and refinancing, increased the nominal stock of debts of HIPCs from US\$55 billion in 1980 to US\$183 billion in 1990 ... by the end of 1995 it had reached US\$215 billion.

The growth between 1990 and 1995 reflected the shift towards grants, higher concessionality and debt cancellations. UNCTAD (1998, p.127) estimated that two-thirds of the increase in sub-Saharan African debt since 1989 had been caused by arrears. Such increases and their effects are creditor-caused damages. The IBRD (1992, pp.10 ff.) stated

[i]n a solvency crisis, early recognition of solvency as the root cause and the need for a final settlement are important for minimizing the damage ... protracted re-negotiations and uncertainty damaged economic activity in debtor countries for several years ... It took too long to recognize that liquidity was the visible tip of the problem, but not its root. [Italics in the original.]

Two IBRD-economists, Ahmed and Summers (1992), quantified the cost of delayed recognition of what is now generally acknowledged as a solvency crisis, calling it “one decade” lost for development. The Bank failed to mention that creditors (including the IBRD itself) had prevented that acknowledgement. At the US Treasury, Summers corroborated his opinion (*Time*, July 24, 2000, p. 45): “Even the toughest private lenders write off their bad debts. That’s what governments – and private lenders – need to do with the bad loans they have made.” Neither the IBRD, nor the US, however, have acted accordingly – so far. Treasury Secretary Paul O’Neill’s suggestion that an international bankruptcy law should be established that would allow countries with excessive debt burdens to work out debt reduction agreements with their foreign creditors instead of depending on IMF bail-outs is, however, encouraging.

5. Assuming exports earnings of US\$600, the conventional debt indicator, based on actual payments, is 5.06% – Debt Service Ratios (DSR = debt service divided by export earnings) are also Interest Service Ratios (interest payments/export earnings) in our example. They hide accumulating arrears. The less countries pay, the bigger the debt overhang grows, and the lower DSRs become. If the debt service actually due were divided by export revenues (DSRd*), the result would be 10.4%, or more than double the conventional ratio, which is the same for countries without debts and heavily indebted countries not paying at all. Therefore, Raffer (1996) rec-

ommended dividing actual debt service by contractual due debt service as a suitable indicator for over-indebtedness:

$$0 \leq DSR/DSR_d^* \leq 1 \quad (2)$$

This indicator is 1 if all payments are made on time, and zero if the debtor does not pay at all. In our illustration, this unambiguous indicator, obviously useful in assessing the capacity to pay, is 0.487. Less than half of the debt service due is actually paid. Compared with actual figures, this is not unduly low. Calculating DSR_d^* with readily available IBRD data for sub-Saharan Africa and low income countries during the 1990s, produces values of around 0.2 and 0.4, respectively. In 1992, sub-Saharan Africa's DSR_d^* was 0.126 (Raffer 2001): the region paid roughly one-eighth of its contractual obligations. The situation improved somewhat after 1992 because even insufficient debt relief is better than none. Nevertheless, the crisis continued.

In the early 1990s, when official creditors declared the debt crisis over, Latin America paid less than half its debt service due. Excluding Mexico, Chile, and Uruguay (as these countries had no arrears, according to official statistics) the index was 0.3497 in 1992, the last year for which the IBRD had published data (rather than projections) by September 1994, when Raffer (1996) was presented as a conference paper at Lancaster. Brazil honored one-third of its contractual obligations, and Argentina, about one quarter. It could also be shown that Miyazawa-Brady-type reductions were insufficient. Only in the case of Costa Rica could a clear positive impact be observed, even though the country's arrears continued. Neither warnings, nor drawing attention to balance-of-payments evolutions, however, were welcome, especially in Mexico during the euphoria that preceded the "Tequila Crisis."

Lessons from History

Generally, sovereign debtors, including developing countries, were treated much more generously in the past (cf. Acosta 2001), that is, before the BWIs became debt managers. The final outcome of Latin American's debt crisis in the 1930s may be seen as a *de facto* insolvency. Following negotiations in 1943, Brazil's debts were reduced by over 75%. "Debt default eased payments constraints" in Chile (Maddison 1985, p. 28). In Colombia, local governments (possibly, municipalities) pioneered debt default, and central authorities fol-

lowed later. Some large European debtors were delinquent in paying their debts after World War I. The British and French governments defaulted in the 1930s, arguing that their peoples' needs were more important than their legal obligations to creditors. The essence of this argument is familiar to insolvency specialists. In the 1940s, nine US states suspended interest payments on their loans when the price of their main export product, cotton, left them short of foreign exchange. US states – sovereign in regard to debt – have a long record of defaulting. The term repudiation was apparently coined in the 19th Century, when Mississippi simply refused to honor its debts.

In 1876, the representatives of private bondholders decided to use Egyptian insolvency law as the yardstick for solving Egypt's debt crisis. How this debt accumulated need not be discussed here, nor its role in Anglo-Egyptian relations. We are interested only in the technicalities of the solution. Evelyn Baring, the administrator who was appointed to protect creditors' interests, did not apply the "lemon squeezer" approach of the BWIs. Instead, he lowered taxes and postal fees, for example, while financing expenditures in public health and education, and encouraging improvements in irrigation. Wages and pensions were paid out in full. Within a surprisingly short period of a few years, his strategy was economically successful for both creditors and debtor alike (Dommen 1999). A hard-nosed 19th-Century capitalist managed that crisis much better and quicker than international public sector institutions do in similar cases nowadays.

After Mexico's default of 1914, the US Ambassador proposed following the example Baring had set in Egypt, but his suggestion was rejected. After years of debt management, debt service was finally geared to Mexico's capacity to pay. Creditors received less than 10% of face values. The Egyptian solution would probably have delivered this outcome quicker and cheaper for everyone involved.

Two spectacular cases of *de facto* composition occurred after 1945: Germany's London Accord and Indonesia's reduction in 1969. In both cases, the existing amount of debt was reduced by roughly one half.

When the debt indicators used then for Germany are compared with those considered "generous" under HIPC II, a technically inexplicable difference between debtors appears. Germany's DSR before debt reduction was below 4%. Unlike the 15% for HIPC II countries, this percentage was considered unsustainable. No doubt the reparations Germany had to pay

after World War I, against Keynes’s advice, were one important reason why that country’s debt burden, although it was relatively much lower than the burden of many developing countries today, was regarded as unbearable for a sovereign debtor in the 1950s – as a factor that was stifling the German economy. But if the German economy was truly being stifled then, how should an even larger debt burden be *sustainable* for much poorer countries now? Table 2 reproduces Germany’s debt indicators as they would be calculated nowadays.

Table 2:
Germany’s Debt Indicators (1949-53)
 (as a percentage of export earnings)

	1949	1950	1951	1952	1953 (Jan.-July)
Debt Stock	358	173	99	85	90
Debt Service	13.7	6.8	3.9	3.4	3.5

Source: Hersel 1998

Scheduled DSR fell from 3.06 (in 1953) to 1.84 (in 1956), and only once exceeded 2%, slightly after 1956 (1958: 2.07), when amortization started after a five-year grace period. The German economy boomed so dynamically that the country outdid its schedule and even made use of contractual possibilities for early repayment. Nevertheless, Germany always paid less than 5% of its export earnings and never more than 60% of its trade surplus. Therefore, the German Jubilee Campaign, the *Erlaszjahr 2000*, demanded an upper debt service limit of 5%. Hersel points out that creditors accepted a German trade surplus, agreeing that debt service generally could not exceed this surplus. Hersel (1998, p. 22) concluded: “if the West Germany of 1952 were analyzed under the current conditions of the HIPC Initiative, it would not be eligible for any debt reduction.” Germany, which was never forced to adopt a structural adjustment program, was allowed to pursue the very opposite and successful economic policies that are characterized by the term “social market economy” (*Soziale Marktwirtschaft*). These policies triggered the so-called German “Economic Mir-

acle” (*Wirtschaftswunder*). Neither the IBRD nor the IMF estimated Germany’s capacity to pay. Instead, a German national, Hermann J. Abs, was asked to *tell* the creditors how much they should cancel.

Abs was also the mastermind behind the debt reduction for Indonesia in the 1960s, which, in many ways, resembled the debt reduction for Germany. Both the creditors and the debtor accepted Abs in this role. Although most of his proposals were followed, he did not have a formal arbitrator’s decision power. One may thus speak of a successful example of mediation, even though it was always clear that both parties were willing to implement his advice, an unusual feature with mediators in general. Although most of Indonesia’s debts were public debts, the composition also covered private claims. Abs (1969, p. 9) insisted that strictly equal treatment of all creditors was “indispensable for any settlement of debts.” As Indonesia also had substantial debts to Communist governments, this demand was also politically important.

As creditors refused to recognize Indonesia as a precedent, Abs (1968) had to find special reasons why this solution was unique and inapplicable to other debtors. These included the following:

- *All the old debts had been contracted by the previous government.*
- Indonesia’s debts consisted predominantly of *credits that had little or no economic usefulness*; and practically the entire cost of debt service had to be financed by the national budget.
- High inflation could only be brought under control through energetic policy measures and *exceptionally generous help from outside sources.*
- *The country would be unable to repay its debts in the future.*

Indonesia’s debtors, especially the Paris Club, obviously accepted these reasons. Logically, this solution would be suggested for many current cases if these criteria were applied – without necessarily creating a legal precedent. When Ghana demanded “Indonesian type” relief a short time later, creditors, however, were reluctant to grant comparable terms, explaining that decision by their desire to avoid setting precedents. Eventually, Ghana was granted very “generous” terms (Hutchful 1987, pp. 273 ff.), which have, however, remained undisclosed until this day. After timid attempts to propose Indonesia as a model during the 1980s, the IBRD now tries to create the impression that Indonesia never received a debt reduction.

More recently, Poland and Egypt have received substantial debt reductions. Although these cases were politically motivated, they nevertheless show how quick and simple debt reduction can be when creditors agree.

Present Strategies

Debt management (for its evolution cf. Raffer and Singer 2001, pp. 158 ff.) was initially based on the “illiquidity” theory. According to this theory, countries would “grow out” of debt. Therefore, there was no need for debt reduction (Venice Terms, “Baker Plan”). As our numerical illustration shows, the long-term debt of all developing countries roughly doubled between 1982 and 1989, from US\$546.9 billion to US\$1,114.9 billion (compound growth rate: around 10% p.a.), when the US decided that debt reduction was necessary.

Recognizing the necessity for reducing the debts of middle income countries (Miyazawa/Brady), and, at about the same time, of poor countries (the Toronto Terms) was a positive change. As Miyazawa/Brady addressed only private creditors, this decision on debt reduction remained insufficient to promote sustainable viability. After 1982, when the composition of debts shifted towards higher shares from official creditors, the probability of success was reduced even further. To get the “seal of approval” by replacing commercial banks’ claims with multilateral money that would be served at any costs was problematic. Although the “Brady deals” did not demonstrably restore economic viability in any “Brady country,” Ecuador’s formal default on its “Brady bonds” in 1999 was a clear and undeniable proof of failure. Ecuador’s sustainability had not been re-established. Although commercial banks granted 45%, which was quite generous, Ecuador’s debt time series showed only a very small blip downwards as new official money increased debts again. In contrast to new loans which are useful and needed for profitable projects after a debtor has been granted a fresh start, such new debts during an unresolved crisis only decrease the positive effect of debt reduction, and prevent the country from getting a fresh start. If all creditors had reduced by 30%, the commercial banks would have saved 15 percentage points, and, in all probability, Ecuador would have regained sustainability. However, such a reduction would have required both a comprehensive approach and equal treatment for all creditors. Debt reductions by only one group of creditors are likely to be

insufficient. As the present situation of Latin American debtors proves, neither Brady nor the debt reduction option under the Enterprise for the Americas Initiative has been able to restore sustainable financial stability.

Now, after the Asian crash, corporate insolvency procedures are seen as an essential means for avoiding future crises. The reports on International Financial Architecture have strongly recommended such procedures, although they have avoided any mention of insolvency with regard to sovereign debtors. The Working Group on International Financial Crises has proposed an insolvency procedure in all but name, demanding that the international community provide “in exceptional and extreme circumstances ... a sovereign debtor with legal ‘breathing space’ so as to facilitate an orderly, cooperative and negotiated restructuring” (OECD, ed., 1998, p. 37).

Emulating insolvency features, such as debt reduction by a qualified creditor majority or “collective action clauses” for sovereign bond contracts, was recommended as a critical contribution to “creating the institutional structure needed to encourage orderly workouts” (ibid., p. 21), because a “binding insolvency regime for sovereign debtors is unlikely” (ibid., p.19). Such clauses, however, would only be helpful in future crises. The Report even admits that “a purely voluntary approach” might not be feasible because “the government may not have the bargaining power to obtain sustainable terms” (ibid., p. 30), e.g., if the creditors demanded de-stabilizingly high interest rates. The question remains why one shied away from the obvious conclusion – the need for an independent entity empowered to decide – and why all the advantages that are praised in the case of firms are not equally advantageous in the case of sovereign debtors. The fact that bonds are quite a common instrument in the case of municipalities shows clearly that Chapter 9 could easily bail-in this new form of sovereign debt.

Constructive default, as proposed by Adam Lerrick and Allan Meltzer in the *Financial Times* (May 10, 2000), is a viable alternative to bail-outs. It removes moral hazard by private creditors, which – given the harshness of IMF-conditionality – is a bigger problem than that of debtor’s moral hazard. The moratorium (although only on payments to private creditors) is a useful feature known from insolvency. By buying at the guaranteed floor price and cancelling written-down claims to the country repaying the IMF, the Fund would be a facilitator. If the authors are right that few investors would exercise this option, the IMF would largely be a catalyst and the drawings would be small.

While this proposal is a definite improvement over present strategies, it may be problematic in the following cases:

- if debts that are purely private debt losses are socialized (“Asian Case”), thereby increasing sovereign debts;
- if a country’s economic policies (excluding liberalizing capital accounts) did not cause the crisis, it may have to apply unnecessary, even harmful IMF remedies;
- if, as with Miyazawa/Brady, only one group of creditors is affected. This is unfair, and moral hazard with others persists. Writing down only private claims may be insufficient, or the losses may have to be quite large to achieve sustainability, thus triggering higher risk premiums in the future; and
- as the IMF alone sets floor prices, the risk of error is higher than if losses are determined by fair and open procedures. The Fund might then set floor prices with its own lending unduly in mind.

Without institutionalized relief, shifting private debts onto governments remains excessively attractive. Retroactive public “guarantees” had to be granted in Latin America, which increased sovereign debt overhang – generally not by the sovereign debtors’ free choice. Purely private risk was largely socialized during the Asian Crisis, thereby suddenly causing governments with enviable economic records to land in trouble. Possibly because of 1997, the High-Level Regional Consultative Meeting on Financing for Development, Asia and Pacific Region saw “a need for an international bankruptcy procedure. It should be ensured that private debt does not become government debt.” (Jakarta, August 2000.)

In parenthesis, one might mention that exercising IMF-membership rights to capital controls on all but current transactions would, at the very least, have softened the impact on Asian countries considerably. The question remains why the IMF violated its own constitution by preventing its members from exercising their rights. Capital controls temporarily barring outflows are equivalent to unilaterally imposed standstills. As a rule, standstills are economically sensible when they allow proper work-outs. The analogy is an automatic stay of enforcement of claims against debtors that have filed insolvency. Without automatic triggering rules, or an institution demanding the debtor to do so, however, an economically indicated technical

decision risks being misinterpreted as an unfriendly act, even though creditors might understand the technical necessity. Giving the IMF authority to impose standstills is problematic, since it is both a creditor in its own right and dominated by a creditor majority. A stay triggered by FTAP is better.

Ecuador illustrates the shortcomings of Paris Club procedures as well. Between July 1983 and September 2000, Ecuador was at the Paris Club seven times – nearly every other year on average (precisely 0.4 times/year). This fact hardly suggests that efficient, sustainable solutions were being found. In general, too little was given too late. Economically, this reaction does not make sense as phantom debts remain unpayable. If only their growth is curbed, which in itself is positive, the basis for the next crisis is provided. On the other hand, creditor domination has resulted in considerable political leverage of official creditors. Political scientists might call this the main difference between the Paris and London clubs. Bankers are used to calculating in strictly economic terms. When the costs of (re)negotiations, which commercial banks have to pay and earn themselves under market conditions, start to exceed expected payments, bankers are more open to a fair solution. Bankers, such as D. Suragar or Alfred Herrhausen, have been quite vocal in demanding negotiated debt reductions. *Emerging Markets This Week* (No. 26, October 15, 1999) published by the German *Commerzbank* wrote that private creditors would not object to “sovereign insolvency procedures ... in cases of extreme borrower distress” if all creditors shared the losses equally. Involving the private sector seems thus easier than bailing-in public sector creditors, especially multilateral ones. Presently, the Paris and London clubs serve the short-term purpose of defusing immediate crises, although they often cause future crises. In both cases, there are neither rules governing the procedures, nor any independent entity to guarantee fairness. Debtors are totally at the mercy of creditors.

Changes from the Venice to the Cologne terms also recognized the insufficiency of the pre-Cologne measures, and the decades-long ineffectiveness of “Structural Adjustment” to solve the problem. The economic sense behind the Cologne debt service option of achieving reduction “through concessional interest rates and a repayment period of 125 years, including 65 years of grace” (IBRD 2000, p. 171) remains unclear at best. The “bullet option” with an interest rate of 0.0001% (the IBRD does not even dare to mention maturity) would be ridiculed in all other debtor-creditor relations. Politically, however, such solutions provide long-term leverage over debtor countries.

The high percentages of debt relief quoted by the Paris Club are misleading, and make insufficient debt relief look “generous.” As only the debts made before the so-called “cut-off date” are “eligible,” their percentage decreases as new debts – including new capitalized arrears as a result of insufficient reductions – accumulate. Eventually, 100% “debt forgiveness” (of the eligible debts) may thus mean reductions that are, in fact, less than 1% of total debts. Mathematicians might joke about actual debt reduction converging on zero, while the percentages “forgiven” converge on 100 – in plain English, this represents a 100% Paris Club “debt relief” situation, where not a single cent has actually been cancelled.

Errors that produce insufficient debt relief initially are perpetuated, and compromise viable solutions in the future. Applying the NPV-concept to debts is also highly misleading, and the higher the discount rate, the more misleading this is. Discounting future debt service payments with non-concessional interest rates reduces debt burdens considerably *on paper*. It frontloads solutions. It is then easier to reach a given NPV-reduction with reductions for the immediate future, which might cause problems later on. Discounting debts at market interest rates simply means that if debtors could invest NPVs today at the discount rate, all debts would be covered. This is logically true, but unhelpful. The HIPC thresholds qualify as such precisely because they do not have any spare money for such investments. Usually, they are not able to honor all of their financial commitments even at concessional terms, which are already too tough for them. Finally, the HIPC thresholds of “sustainability” were arbitrarily chosen, possibly in order to keep the nominal costs to creditors down. Countries may either pay as much after debt relief as before – or even more. Debtors that would qualify by objective indicators (such as Indonesia or Nigeria) are excluded arbitrarily – a decision that accommodates the creditors’ short-term and shortsighted interest in “keeping down” nominal costs.

Paris Club decisions are unfair to both debtors and non-member creditors. Its demand that the debtor seek similar treatment from other creditors shifts the burden onto the weakest. Although non-members are not represented, the Club’s decisions affect their claims. Relative to their economic situations (measured, e.g., by GDP/head), the burden might well be much larger. Gunther (2001) proposed that burden-sharing be adjusted accordingly. He quoted the examples of Costa Rica, which incurred

higher costs (in dollar terms) than the US, and of several developing countries that have to pay a multiple on a *per capita* basis of what any Paris Club member pays under the present rules. Having to implement Paris Club HIPC relief may endanger the sustainability of other developing countries.

Well-founded doubts already exist as to whether HIPC II will achieve its goal of returning poor country debtors to sustainability. It suffices to quote the US General Accounting Office (GAO 2000), which assessed HIPC II upon congressional request. Debt sustainability depends on annual growth rates above 6% in US dollar terms over a 20-year period. In four cases, including Nicaragua and Uganda, that rate is even above 9.1%. Understandably, the GAO doubted whether such rates could actually be maintained for that long, warning that commodity prices tend to volatility. It pointed out that additional money would be necessary. Like so many previous creditor initiatives, HIPC II is apparently built again on fragile, optimistic assumptions and forecasts. With good reason, the Zedillo Report states that HIPC II has, “in most cases,” (p. 21) not gone far enough for sustainable debt levels to be reached, and suggests a “re-enhanced” HIPC III (p. 54).

Fair Transparent Arbitration Process (FTAP)

The Feasibility of FTAP. FTAP has its roots in a proposal which was made soon after August 1982 by the banker David Suratgar. He suggested that corporate insolvency, which is known in the US as Chapter 11, Title 11, be applied to sovereign debtors. This idea had also been advocated by UNCTAD and, early on, by Jeffrey Sachs. The Egyptian example shows that this proposal is economically a perfectly sound idea. Nevertheless, a legalistic, formal “killer argument” came in handy. It has been argued that Chapter 11 could not be applied to sovereign debtors, because, of course, insolvency procedures for firms do not address sovereignty, nor governmental powers in general. This is correct as far as it goes. The US, however, does have insolvency procedures for debtors with governmental powers, or so-called municipalities, which grant debtor protection to the municipalities and their inhabitants: Chapter 9 of Title 11. In 1987, Raffer already reacted to the legalistic counter arguments against Chapter 11, and proposed internationalizing US Chapter 9 (Raffer 1989). Chapter 9 proves that there is no

legal argument against insolvency-type protection for sovereign debtors. The only successful solution, generally accepted for other debtors, could be applied to countries as well. Although sovereign debtors borrowing on international capital markets routinely waive immunity, it was proposed that a neutral arbitration panel, rather than a national court should decide. People, especially from the South, therefore, often refer to this solution as “FTAP,” or “debt arbitration for countries,” obviously preferring these expressions to “insolvency.” FTAP modeled on Chapter 9 has been elaborated on in detail elsewhere. (See Raffer 1990 and more recent publications in English, French and Spanish at <http://mailbox.univie.ac.at/~rafferk5>). Thus, only the essential elements of FTAP are presented here to show, briefly, its feasibility and implementability.

The Essence of FTAP. The important point in FTAP is that it applies the fundamental principles of insolvency protection. The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles. In a situation of over-indebtedness, the right of creditors to payments collides with the generally recognized principle in all civilized legal systems (and not only in the case of loans) that no one can be forced to fulfill a contract that leads to inhumane distress, endangers one’s life or health, or violates human dignity. The normal sanctity of contracts to which the Zedillo Report (p. 52) rightly refers is always overridden by debtor protection. Put briefly: debtors cannot be forced to starve their children to be able to pay. Although creditor claims are recognized as legitimate, insolvency exempts the debtor’s resources from being seized by *bona fide* creditors. Human rights, human dignity, and the debtor’s “fresh start” enjoy unconditional priority.

Insolvency relief is not an act of mercy, but of justice and economic reason, and this is true right down to negligible details. For example, the word *forgive* is not commonly used when insolvency procedures reduce debts. Reduction is a *right* of insolvent debtors – even if they are not “deserving, good boys.” Developing countries, however, have to beg for “forgiveness.” Insolvency only deals with claims based on a solid and proper legal foundation. No insolvency is needed for “odious debts.” These are null and void. Demands for cancelling apartheid debts, for example, are therefore based on the odious debt doctrine.

The other basic feature of insolvency is the most fundamental principle of the Rule of Law: no one is allowed to judge in his own case. Civilized insolvency laws, which are applicable to all debtors except developing countries, require a neutral institution in order to ensure fair settlements. Creditors are not allowed to decide on their own claims. Even during the debt slavery era, creditors were not allowed to decide whether a debtor should be enslaved. Only judges could do so. Unrestricted creditor domination is an open breach of the Rule of Law, a principle presently preached to developing countries by the OECD governments. Creditor domination is also inefficient from a purely economical perspective, as the current prolonged debt crisis proves.

Arbitration-Mediation. To start FTAP, sovereign debtors could “file” for debt arbitration/insolvency protection by depositing this request at the UN, e.g., with the Secretary-General. Clearly, only debtor governments would have the right to file, as this is their sovereign decision. In addition to serving as the organization where sovereign debtors could file requests for an arbitration process that would weigh fairly the interests of creditors and the debtor, the UN could play an important role in organizing the nomination of arbitrators by the two parties. It could also provide them with the needed secretarial services. Each party would nominate one or two persons, who would then elect one further arbitrator. Filing would trigger a stay. Vulture funds would no longer be able to hold debtor governments and other creditors hostage, as lawsuits against the debtor – and harassing other creditors – would no longer be possible.

Arbitration is a traditional mechanism of international law that is routinely used by the WTO and NAFTA, and was suggested for the now shelved MAI. Arbitration is generally quite popular with creditor countries, except when it is used to protect the poorest. Even in creditor-debtor relations, arbitration is not new. Arbitration clauses were fairly standard before World War II. Arbitration to solve disagreement with creditors was part of the London Accord on Germany’s debt. Incidentally, Raffer (1989) used that case as a supporting example for his proposal. Some recent agreements with private creditors also foresee arbitration (Rocha 1999, pp.132 ff.). Official creditors differ nowadays. In the course of the bilateral negotiations under the auspices of the Paris Club, Brazil was forced to

change legal requirements in order to “exempt specifically ... Paris Club bilateral restructuring agreements” from arbitration (*ibid.*, pp. 91 ff.).

The Zedillo Report proposes arbitration in matters of taxation and investment, but not for debts. Instead, it demands a “new mechanism to mediate relations between debtor and creditor countries” (p. 34). No argument is offered on why a mechanism that has proven useful in resolving friction between countries in matters regarding taxation and in attracting private foreign direct investments should be inappropriate for settling debt problems. The Zedillo Report reflects the Secretary-General’s Report (p. 64), where an “independent” mediator is proposed, assisted by the IMF and other experts (the IBRD would certainly be considered) as an additional, voluntary option. One might argue that mediation worked in Indonesia in 1969. Logically, it could work even with creditors (especially the IMF) absolutely dominating the procedures. Creditor behavior since 1982, however, does not suggest that the results are likely to be sustainable, if such creditor domination continues.

Good arbitration comes very close to being mediation. Arbitrators should encourage all the parties involved to reach fair and feasible outcomes. Ideally, when the creditors, the debtor and the organizations representing the population are all in agreement, there would be *de facto* no differences. Whereas mediators can only appeal to both sides, provide arguments and help as uninterested parties, arbitrators can make decisions, a capacity that can be useful in reaching agreements. However, one cannot always assume the ideal case of purely formal “decisions.” Arbitrators have to decide on the basis of arguments, data, and the information presented during the proceedings. Thus, their decisions are likely to affect only small sums. As an improvement over present management, mediation does not confer the same status on debtors that arbitration does. They are not equal parties. The informal process depends wholly on the creditor’s good will, which is not overwhelming. Arbitration, by contrast, has established rules that place both sides on an equal level – as parties with equal rights. There is no reason why sovereign debtors and the world’s poorest should not enjoy this basic protection by the Rule of Law, which mediation can deny. Therefore, the Secretary-General’s first proposal is preferable, even though mediation was, no doubt, proposed after conscientious and careful deliberation.

Sovereignty. It has been repeatedly argued that Chapter 9 cannot be adopted because countries cannot be put into receivership. A study of the Advisory Council of the German Ministry for Cooperation (BMZ 2000) referred to the “strict supervision” of private debtors (!) in German law and concluded that “political sovereignty and, linked to it, the impossibility to remove governments” would not permit an international Chapter 9. In a response to a parliamentary enquiry in the Swiss parliament (*Bundesrat*), the Swiss government argued that US Chapter 9 would be incompatible with sovereignty because “external authorities” would, as a rule, be “appointed to manage the finances of insolvent states and municipalities” (*Bundesrat* 2000). This answer overlooked that fact that the individual states in the US are considered sovereign in regard to debt, according to the 11th Amendment of the US Constitution. It is hard to explain how a parliamentary enquiry could be answered so incorrectly and misleadingly, assuming, of course, that the government had drafted its answer with appropriate care.

Chapter 9 was introduced during the Great Depression precisely to avoid prolonged, inefficient negotiations and rescheduling, and to allow quick, fair, and economically efficient solutions for over-indebted US municipalities. A first draft of Chapter 9 by the municipalities failed to bar creditor intervention in governmental spheres and was rejected by the lawmakers as unconstitutional. Creditor interventions such as those that are commonly practiced today in developing countries were considered unacceptable. A new version containing §904 was then passed. Entitled “Limitation on Jurisdiction and Powers of Court”, §904 states with utmost clarity:

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with (1) any of the political and governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor’s use or enjoyment of any income-producing property.

The concept of sovereignty does not contain anything more than the protections included in §904. The court’s jurisdiction depends on the municipality’s volition, and cannot be extended beyond that, a feature that is similar to the jurisdiction of international arbitrators. A municipality cannot go into receivership. Unlike other bankruptcy procedures, no trustee can be ap-

pointed. §902(5) explicitly states that “‘trustee’, when used in a section that is made applicable in a case under this chapter ... means ‘debtor’.” For the legalistically minded, one should add that §926 contains an exception if the debtor refuses to pursue avoiding powers, thereby allowing a third party to void specific transactions with particular creditors. Elected officials cannot be removed from office by the court. All of this makes Chapter 9 especially well suited to be *the* instrument for solving sovereign over-indebtedness.

Debtor Protection. Over-indebted municipalities are not expected to stop providing basic social services that are essential to the health, safety and welfare of their inhabitants just so they can pay their creditors. They enjoy debtor protection. In the Asbury Park case, the US Supreme Court clearly stated that a city cannot be taken over and operated for the benefit of creditors. There is a public interest in keeping a debtor functioning normally that overrides creditors’ interests in higher payments. Tax increases that would depress the standard of living of the population of a municipality below the minimum guaranteed to private debtors are also clearly illegal. Feasible tax increases have, in fact, been much lower.

The affected population has a right to be heard. They can voice their opinions and object to any plan proposed. The court must hear them, but need not, of course, follow or obey any of the views expressed. Internationally, the population affected by a similar plan would have to be represented. Trade unions, entrepreneurs’ associations, grassroots organizations, religious and non-religious NGOs, or international organizations, such as UNICEF, could represent the population and exercise its right to be heard. Fair and equitable proceedings, and the possibility of describing the expected effects on the poor in public, would certainly have mitigating effects and contribute to an adjustment with a human face. In addition, the arbitrators would have to take particular care to ensure that at least a minimum of human dignity would be safeguarded for the poor in the debtor country – in the same way the courts must safeguard human dignity in domestic US Chapter 9 cases.

Similar to the treatment of US municipalities, it must be forbidden to raise money for debt service by destroying basic social services. The principle of debtor protection demands that resources necessary for financing minimum standards of basic health care service, primary education, and so on for the poor, as well as funds that are needed for sustainable economic recovery

remain exempt. This exemption can only be justified if the money is clearly used for its declared purpose. A transparently managed fund financed by the debtor in domestic currency for poverty reduction and for fuelling a fresh start of the debtor's economy would dispel any concerns. The management and monitoring of such a fund could be entrusted to an international board or an advisory council composed of members from the debtor country as well as from creditor states, nominated by governments (including the debtor's) and NGOs. As such a fund would be an independent legal entity, checking on these projects would not – in contrast to present strategies – be a matter for the government's budget, which is an important part of a country's sovereignty. This would also be an improvement. So far, counterpart funds have worked quite successfully. Regarding decisions on the use of this money, the government's situation remains unchanged. The money it would have paid to creditors would be paid into the Fund.

Equal Treatment of Creditors. All creditors should be treated equally. As a matter of fairness to debtors and other creditors, the same percentage must be deducted from all debts. The strong growth of debts, in particular multilateral debts, during the period 1982 - 1999 in the 23 HIPCs that had reached the decision point by July 2001 does not suggest efficient and successful trouble shooting by the multilaterals in charge. Apparently, multilateral loans were given to service other credits, and arrears increased multilateral debts further. Successful debt management would have stopped the growth of such debts by giving debtors a fresh start with new opportunities and renewed market access.

Sometimes, multilaterals may even gain financially from their errors and failures. One harmful program or bad project often leads to the next, thus increasing the institution's income and importance. This result is at severe odds with any market principle. Equal treatment is one way to hold multilaterals financially accountable in the same way private creditors usually are for their decisions affecting debtors. Compensation for damage done within projects, where determining faults and errors is much easier, is an issue in its own right, and would help reduce the debt burden further (Raffer and Singer 2001).

Multilaterals use the flawed argument that their own rating as borrowers would deteriorate, without "preferred creditor status," and that this would increase the costs of lending. If defaults that are publicly known, al-

though officially denied – cases of countries that have not paid for years – have not reduced the IBRD’s rating, then properly acknowledged and handled defaults are hardly likely to do so. Apparently, the BWI’s ratings owe more to the guarantees granted by the OECD governments than to their lending record. All multilateral development banks have loan loss reserves. Using them as foreseen does not cause ratings to deteriorate, nor does it increase the costs of future lending, since the existing reserves have already been financed by borrowers. In spite of this preferred protection, multilateral development banks (MDBs) have charged loan loss provisioning costs, thus “having their cake and eating it, too.” The borrowers continue to pay mark-ups for loan loss provisioning without getting any benefits from the very relief option they are financing. There might be, at worst, a marginal effect, if interest income from reserves (if there were any) were used to reduce the lenders’ margins. However, given the volume of the loans, reserves and possible interest that might be used, this does not seem to justify the concerns expressed in the Zedillo Report.

Statutes of multilaterals foresee default. Article IV, 6 of the IBRD’s *Articles of Agreement* demands a special reserve covering “Methods of Meeting Liabilities of the Bank in Case of Defaults.” As the Bank’s business is restricted to members (Article III, 4), it follows that sovereign default is considered a possible, and, on occasion, even necessary solution. Unaware of any preferred creditor status, a legal concept that cannot be found in its *Articles of Agreement*, the Bank’s founders wanted the IBRD to be subject to market discipline, rather than totally exempt from it. Mechanisms were designed that allowed the Bank to shoulder risks appropriately, and debtors have financed them. Thwarting its founders’ intentions, the IBRD has refused to use these mechanisms, wrongly claiming that to do so would make development finance inoperational. The IBRD’s very statute proves that financial accountability is necessary and possible. The European Bank for Reconstruction and Development (EBRD) writes off losses, and submits to arbitration, a process that was also foreseen for the IBRD, thus proving that MDBs can survive financial accountability and market risk.

Poor countries are usually soft window clients. Funds, such as the IDA, can simply waive repayments without any economic problems. Doing so, however, reduces future loan volumes by the amounts waived,

unless new money is paid-in. The Zedillo Report (pp. 52 ff.) observes that countries whose credit volumes decline more than IDA debt service are paying for the debt relief of others. This is a problematic statement, particularly if one concurs with the Report that the present IDA terms need substantial softening, if the necessity for another HIPC Initiative is to be avoided. This remark suggests that the present volume and terms of IDA loans *create* rather than *solve* problems – and that US\$1 of debt reduction is worth more than US\$1 in aid. The discussion on “ownership” suggests that countries are not necessarily keen on all projects – and the economic results of lending would suggest, rightly so. (See Raffer and Singer 2001, pp. 246 ff.) Finally, if attached conditionality and economic efficiency are taken into account, IDA loans are not as cheap as they appear at first sight. If program lending and particularly new loans that enable debtors to repay earlier loans ceased, as they would if debtors were given a fresh start, demand for IDA resources would, in all likelihood, fall. Introducing financial accountability for the multilateral development banks would prevent many disastrous projects, a development that would be very much in the interest of the debtors who have to pick up the bill. If, against all expectations, credit demand still exceeded supply, those countries that have gotten proportionately more debt relief (thus reducing reflexes proportionately more) could reduce their credit demand proportionately, but not by more than the amount of the reductions they had actually received. As a dollar in relief is better than a dollar in new loans, they would still be better off.

The IMF poses some difficulties. As conditionality was not initially foreseen, loan loss provisions were regarded as unnecessary. When conditionality was introduced, no appropriate changes were made in regard to the Fund’s accountability for the decisions it made affecting its clients. This oversight became particularly problematic once the Fund started massive debt management operations. Thus, introducing financial accountability for its own decisions is all the more important. Losses are one way to do so. Gold sales (revaluation) would be another way for the IMF – whose exposure is much smaller – to cover losses. The developing countries may represent a possible exception from equal treatment. It does not make sense to bankrupt Country A by relieving Country B. In these cases, preferential and differential treatment, which would be de-

cided strictly according to certain objective criteria, such as claims affected, the creditor's GDP/head, or export income, would probably be useful. Alternatively, developing countries that cancelled debts within FTAPs could be automatically entitled to reductions, representing the values of their cancellations by their own creditors. It must be emphasized, however, that this exception results from technicalities of implementation and economic sense.

Access to Capital Markets and New Loans. It is often argued that insolvency bars future access to capital markets. If this were true, no re-organized firm could ever get a new loan – a supposition that daily experience proves manifestly wrong. Similarly, David Clementi, the Deputy Governor of the Bank of England, saw no empirical evidence of “any discernible negative long-term effect of a country's prior debt servicing record on the terms and volume of its borrowing.” (UN 2000, p. 19). After its *de facto* insolvency in 1969-70, Indonesia's public sector was permitted to overborrow again so quickly that the Pertamina crisis erupted in the mid-1970s. Economic logic suggests that the long-term investments and capital flows needed for development probably will not flow into crisis countries, but will become available for profitable projects once crushing debt overhang is removed, and debtor countries have started a new financial life, based on regained economic viability.

Systemic Role. Last but not least, FTAP is needed as an important part of a New International Architecture, as a disincentive to irresponsible lending. If they were sure to lose their money eventually, lenders would stop lending, if previous loans had not been put to efficient use. Debts could not accumulate as they do now. If FTAP had existed in the 1970s, the current debt burden would be much lower, and perhaps there would be no debt crisis at all since lenders would not have operated on the assumption that they would get paid. It would have been clear from the start that all creditors would be bailed-in, not bailed-out. Multilateral activities would probably decrease so that fewer, but more economically viable projects would be financed. This would certainly be desirable since no project at all is preferable to a costly flop – at least for those who have to pay for it.

Conclusion

A sustainable solution for removing debt overhang is an important precondition for successful development and for the Financing for Development Initiative. Without it, all development activities remain at risk. Some aid will continue to be diverted for bail-outs, and many resources will not be mobilized because investors will rightly fear the next, predictable crisis. New money for investments in development will not flow because the debt problem has not been solved. A sound basis for starting renewed development efforts is mandatory. FTAP is socially, legally and economically indicated. Without this orderly, efficient and fair procedure, financial crises are prolonged, and damage will continue to be inflicted unnecessarily, primarily on the poorest, most vulnerable groups. The very foundation of the Rule of Law demands neutral institutions that ensure fair settlements. The human right of debtor protection must not be denied to any human being, whether living in the North or the South. All human beings must be treated equally. Arbitration must prevail over arbitrariness – also in regard to sovereign debt.

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Financial Crises and the Private Sector: Reducing Moral Hazard

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Abstract

Emerging market economies are particularly susceptible to financial crises, which lead to dire consequences at home and abroad: they stunt domestic growth and can spill outside borders and hurt healthy economies. When emerging market countries suffer financial crises, to limit contagion and prevent default, it is in the interest of all countries to restructure private and public debt. Individually, however, no private lender has the incentive or the ability to make the necessary loans, although, collectively, all countries benefit if each one does its part. In other words, emerging market financial crises present a global coordination problem. Thus, we need an international lender of last resort.

The International Monetary Fund (IMF), acting as a supranational lender of last resort, can solve the coordination problem, but in doing so it simultaneously incurs moral hazard in relation to international private lenders: by promising to act, if necessary, as a lender of last resort, the IMF may encourage excessive risk-taking and thereby induce, rather than prevent, financial crises.

We propose measures to improve risk allocation, limit the moral hazard arising from IMF lending, and spur the private sector to tighten debt monitoring. These measures include making default painful, building trust, applying flexible rules to negotiations, supervising credit markets in both creditor and debtor countries effectively, improving information flows, conditioning IMF lending, keeping mediation mechanisms free from political pressures, and using collective action clauses and standstills cautiously.

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Introduction

Emerging market economies are particularly susceptible to financial crises, which lead to dire consequences at home and abroad: they stunt domestic growth and can spill outside borders and hurt healthy economies. Domestically, financial instability often calls for intervention by a lender of last resort. When emerging market countries suffer financial crises, to limit contagion and prevent default, it is in the interest of all countries to restructure private and public debt in emerging economies. Individually, however, no private lender or national lender of last resort has the incentive or the ability to make the necessary loans, although, collectively, all countries benefit if each one does its part. In other words, emerging market financial crises present a global coordination problem.

The International Monetary Fund (IMF), acting as a supranational lender of last resort, can solve the coordination problem, but it simultaneously creates a problem of moral hazard for itself in relation to lenders and their shareholders: by promising to act as a lender of last resort, it may encourage excessive risk-taking and thereby induce, rather than prevent, financial crises. Yet, if the private sector can be induced to get involved in monitoring and supervising credit markets, it can mitigate moral hazard.

Part II provides background on moral hazard, international finance, and lenders of last resort. Part III is a critical review of the policy proposals in vogue today that were designed to mitigate moral hazard. Part IV contains specific policy recommendations to garner private sector support in solving moral hazard problems.

Background

A country is said to be undergoing a financial crisis when its credit system breaks down. A single bank may fail, or falter, and this can lead to spillovers throughout the system, as credit markets are held together by a chain of expectations regarding various players' ability and willingness to make good on their debts. Emerging market economies (EMEs) are especially vulnerable to financial crises. They often depend on a few commodities, their financial systems are weak, and confidence is easily lost because of external shocks, unsound macroeconomic policies or distressed borrowing by the private and public sector. Financial crises in EMEs are marked by sudden and dramatic capital outflows and either currency depreciation or devaluation, or strong pressures on international reserves, or both.

Financial crises, if left unchecked, can have dire real effects on the domestic economy, and provoke negative externalities across borders. Healthy financial markets channel a country's savings into productive investment. When these markets break down, investment cannot be funded and domestic growth is hampered. Serious crises can cause severe economic contraction: Mexico's gross domestic product fell 6.2% in 1995, and in 1998 the Asian crisis caused output to fall 5.5% in Korea and 13.7% in Indonesia.¹ Many have argued that in the United States, the Great Depression was caused, and later worsened, by a string of bank failures that took place during the early 1930s.²

Crises can spread from the original stricken country to healthy economies when investors respond to an isolated crisis by exiting in droves from any other emerging economy in which they perceive a similar risk. Current account shocks also channel financial crisis externalities: trading partners tend to ride business cycles in tandem. This often results in the self-fulfilling prophecy of a spillover crisis: "contagion." Fortunately, contagion, though still important, seems today to be on the decline.

Emerging markets depend heavily on external financing. They often lack adequate financial capital but have abundant labor pools and large natural resource stocks. Also, they are at a relatively early stage in their industrialization, which means that investments can generate high returns. Hence, emerging markets enjoy high growth potential, and thus easily attract funds from industrialized lenders with abundant financial resources but flatter growth potential in their home countries due to decreasing returns to scale. Capital markets, then, allow funds to migrate from industrialized countries to emerging economies, where they can produce the greatest gain. This is a nice arrangement for everyone ... as long as everyone avoids a financial crisis.

Private financing is the most important source of funds for EMEs. In 2001, nearly 90% of total external financing for EMEs is expected to come from private sources (US\$140 billion), and that portion could swell to 99% in 2002.³ In international capital markets, private lending is becoming more important than government lending.

1 World Economic Outlook (1999), as reported in Mishkin, Frederic S. 1991. "Global Financial Instability: Framework, Events, Issues." *Journal of Economic Perspectives*. 13:4, pp. 3-20.

2 For a review of the evidence, see Bernanke, Ben S. 1983. "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression." *American Economic Review*, 73, pp. 257-276.

3 Institute of International Finance. May 31, 2001. Report on Capital Flows to Emerging Market Economies. Washington, DC.

Capital markets channel two types of private financing to EMEs: debt and equity. Debt financing involves bank loans and bond placement. Equity financing includes foreign direct investment (FDI) and portfolio equity investment. Thus, we have four markets for capital, each with its idiosyncrasies and unique potential for conveying spillovers. Table 1 provides a comparative glimpse at these markets to help us identify those most likely to serve as conduits for spillovers. Later we will come back to Table 1 to pinpoint the sources of coordination failure requiring action by an international lender of last resort.

Most external funds flowing to EMEs are channeled through equity markets. While portfolio investment in equity in general is volatile, a large proportion of these funds flowing to emerging market economies (US\$148 billion average per year from 1998 to 2001) take the form of foreign direct investment, which is stable. Bond financing accounts for a much lower proportion of total financing and is highly volatile. It is true that the market for emerging market bonds is large: with US\$600 billion outstanding, it is slightly larger than the domestic high yield market in the US. However, the net annual flow in 2000 was only US\$26 billion, and in any given year, this number can easily turn negative. The emerging economy bond market is quite sensitive to the quality of macroeconomic management in the debtor country, interest rate changes in industrial countries, expectation changes and, of course, the risk of non-voluntary restructuring. Countries that are perceived to be pursuing poorly conceived economic policies will quickly find they have to pay high rates or are even excluded from the market.

Bank loans fall between the two extremes: loans are usually short-term, but they are channeled through credit lines managed with a long-term perspective. Even so, creditor banks can (and often do) move quickly to reduce their exposure in the event of problems. They know they have special clout when the country is in crisis, and they exert strong influence on the sovereign to take on the debt of quasi-sovereign and private sector debtors.

Note the correlations between contract characteristics (myopic vs. long-term, personalized vs. anonymous) and financial volatility. When contracts are short-term (bonds) or open-ended (stocks), and contracting is anonymous (as in bond and equity markets), they induce volatility. Long-term, personalized contracts such as those involving bank loans lead to greater stability.

Table 1:

Debt vs. Equity Markets as Potential Conduits for Financial Crisis Spillovers

	Debt (loans and bonds)	Equity (FDI and portfolio)
Weight as a portion of total EME international funding	Low.	High.
Volatility and thus potential as a conduit for contagion: massive capital outflows from other EMEs, ones originally not in crisis	Bonds: high. Bank loans: medium.	FDI: Low. Portfolio: High.
Potential for default as a conduit for international spillovers onto investors and their home country economies	Bonds and bank loans: the potential is present.	Does not apply.
Potential for collective action problems in the event of a financial crisis	Bonds and bank loans: high.	None. No coordinated response is appropriate in this market in the event of a financial crisis.
Typical time to contract maturity	Bonds: variable. Bank loans: usually short.	Open-ended.
Contractual relationships	Bonds: anonymous and myopic. Bank loans: personalized and long-term.	FDI: Relationships between strategic corporate partners are personalized and long-term. Portfolio: Relationships between the domestic corporation and foreign shareholders are anonymous except in the case of majority shareholders.

Source: World Bank: GDF 2001, tables 2.2 and 2.6.

Within national economies, one solution to financial crises is intervention by a designated lender of last resort, usually the central bank. This lender solves a coordination problem. It is in the interest of all domestic creditors that illiquid but solvent financial institutions be lent the funds necessary to prevent a financial system breakdown. Crisis avoidance or containment is the “good equilibrium,” the outcome we wish to attain. Yet, no single lender has, individually, the incentive, or perhaps the strength, to loan such a quantity. Left alone, the system will collapse. This is the “bad equilibrium,” the outcome induced by the system’s coordination failure. If the lender of last resort steps in, however, either to lend its own funds or channel funds from taxpayers or private creditors, it can prevent the coordination failure (avoid contagion), and thus prevent or contain a financial crisis.⁴ Unfortunately, these actions by lenders of last resort will induce moral hazard.

Moral hazard⁵ is said to be present in a risky project if it is difficult to determine whether genuine bad luck or mismanagement (shirking) caused an adverse outcome. It is rooted in a particular kind of information asymmetry – namely, hidden action: the project is run by an agent who is shielded from the costs of project failure, whose actions cannot be observed, and who has an incentive to shirk, meaning to take actions that increase the probability of project failure. By “shirking” we mean mischief like the foolish spending of scarce capital on items that gain high status for the entrepreneur but are not productive, such as certain corporate jets.

Consider a banker who is approached by a potential borrower seeking financing for a risky project. The banker cannot observe the borrower’s behavior “ex-post” (once the contract has been signed): the borrower’s actions are hidden. The banker will lend the money, if he deems the project likely to succeed, and he will assess both sources of risk: the risk inherent in the project, independent of the borrower’s entrepreneurial skills or man-

4 Both Catherine Mann (Mann, Catherine L, 1998, “An International Lender of Last Resort and International Financial Markets,” Testimony before the Senate Standing Committee on Foreign Affairs, Canada, 27 April 1998) and Stanley Fischer (Fischer, Stanley, 1999, “On the Need for an International Lender of Last Resort.” *Journal of Economic Perspectives*. December, 13:4, pp. 85-104) motivate the need for a lender of last resort by noting that these lenders solve a multi-equilibrium collective action problem along the lines of Prisoner’s Dilemma. Fischer attributes this notion to the following reference: Diamond, Douglas and Philip Dybvig, 1983, “Bank Runs, Deposit Insurance, and Liquidity,” June, 91:3, pp. 401-19.

5 This section paraphrases freely from Geneviève Signoret, in a letter to the author, 31 August 2001.

agerial habits; and the risk that the borrower will shirk. Should the project fail, the banker can scarcely determine which of these two sources of risk was to blame. This means he is unable to design a verifiable contract requiring the borrower to perform optimally. Unless the information asymmetry problem is somehow solved, bank lending will be inefficiently low, inhibiting development.

Healthy credit markets control problems of moral hazard through the spontaneous emergence or top-down design of institutions that mitigate moral hazard. These institutions may include certain contractual forms, laws, and cultural norms. They reduce moral hazard and thus induce adequate levels of productive investment in one of three ways:

- By providing for monitoring. Certain contractual forms provide bankers with ways to monitor their customers and thus reduce information asymmetry. Long-term relationships, credit lines, and restrictive covenants are types of contracts that accomplish this.
- By re-allocating risk. Bankruptcy laws re-allocate risk so that default inflicts some pain on borrowers. This is tricky! If you place too much of the risk burden on the borrower, he will not apply for the loan in the first place, entrepreneurial risk-taking will be sub-optimal, and development will be slowed down.
- By enhancing trust. Certain cultural norms reward those who honor their debts, and shun the dishonest. In societies or social circles that stigmatize renegeing on debt, moral hazard is lower and, thus, monitoring is less crucial, lending can expand, and investment will flourish.

In addition to the moral hazard inherent to all credit relationships, when you add a lender of last resort to the picture, additional moral hazard crops up. In this case, the moral hazard afflicts the relationship between the lender of last resort and private lenders. The lender of last resort incurs moral hazard by inducing private lenders to take on excessive risk by leading them to believe that should a crisis ensue, this mega-lender will drop in to rescue all players involved. Thus, a lender of last resort, if the problem of moral hazard is not contained, will induce further financial crises, rather than prevent them.

To mitigate its moral hazard problem, the national lender of last resort establishes rules that make its rescue efforts dependent on the good behavior

of the banks, which implies that it must be able to monitor bank behavior. Hence, the lender of last resort relies on bank regulation and supervision, and the threat of bank closure, to reduce the information asymmetry that breeds moral hazard. As Mann puts it, “On-going supervision of institutions is the *quid pro quo* for very occasional financial support from the central bank or taxpayer.”⁶ This is why, to be effective, supervisors must be on the scene, be privy to information allowing them to discern which institutions are at risk, and be poised to take prompt action to improve or close an afflicted institution.

Over the past two decades, the IMF, acting as a crisis manager, has gradually become an international lender of last resort.⁷ Fischer⁸ distinguishes two functions for this role: lending its own funds and coordinating the lending of others. When a central bank prints rescue money, it lends its own resources, but this occurs less and less. More often, the central bank either persuades private sector lenders to pool resources for lending, or it channels taxpayer funds, or it raises money by issuing bonds. In these ways, it steers liquidity to distressed borrowers.

As in the case of national lenders of last resort, an international body with the same function solves a coordination problem. When a financial crisis arises, all that is needed is debt restructuring and fresh funds. A coordinated response by international private sector lenders, or by national lenders of last resort (lender country central banks) would do the trick. But these lenders and institutions may be slow to reach international agreements, or have diverging interests or mandates. Therefore, although on a global economic scale it is clearly beneficial for all countries to contain the crisis and avoid contagion, creditors are not likely to act jointly to lend strategically, and crises will spread. Hence, the need for an international lender of last resort.

This brings to light the tendency noted in Table 1 for coordination failure in crisis times among international groups of private lenders. Most bond contracts require unanimous approval before restructuring

6 Mann, Catherine L. 1999. “Market Mechanisms to Reduce the Need for IMF Bailouts.” *International Economics Policy Briefs*. February, 99:4.

7 Fischer (1999), op. cit., and attributed to Boughton, James. 1998. “From Suez to Tequila: The IMF as Crisis Manager.” Mimeo. Washington: International Monetary Fund.

8 Op. cit.

can take place. This requirement empowers small groups of recalcitrant bondholders to block term restructuring, which would benefit the whole group.⁹ International private banks, too, may have trouble reaching agreements. With the looming risk that a crisis may deepen further, the temptation is strong to “free ride” on each other’s provision of fresh funds. When all players choose to free ride, nothing gets done. An international lender of last resort solves the problem by coordinating their actions, steering these groups to provide the funding needed to avoid further contagion and other spillovers. In doing so, however, the IMF, like any lender and any lender of last resort, incurs moral hazard.

Moral hazard for the IMF in its role as international lender of last resort is precisely the same as that faced by national lenders of last resort – the danger that once word gets out that the IMF will step in to solve crises, lenders will lend imprudently and monitor insufficiently. Note the embedded chain of moral hazard: the IMF now faces the hazard that private lenders will not monitor enough to contain their own moral hazard, which they incur through their own private lending.

Over a century ago, Walter Bagehot perceived this problem and pointed it out in his 1873 classic, *Lombard Street*.¹⁰ Fischer¹¹ draws from Bagehot and later thinkers to summarize and review a set of rules proposed to govern the actions of lenders of last resort in ways that mitigate moral hazard. These rules dictate that the lender of last resort lend freely to solvent institutions with collateral that is marketable in the normal course of business when there is no panic in large amounts on demand and at a rate of interest higher than the market rate. Bagehot held that these principles should be stated in advance and strictly followed in a crisis. Others advise instead “constructive ambiguity.”

But as Mann¹² points out, even when lenders of last resort follow these rules, the hazard of excessive risk-taking that can lead to financial crises still lurks to an unacceptable degree, which is why national governments also regulate, supervise, and sometimes close down financial

⁹ This problem may be partly alleviated by collective action clauses, examined in Section III.

¹⁰ Bagehot, Walter. 1873. *Lombard Street: A Description of the Money Market*. London: William Clowes and Sons.

¹¹ Op. cit.

¹² Op. cit.

institutions. Mann points out further that there is no international analogue to national bank supervision:

The Basle Core Principles draw out best practice from national financial regulations, but the Bank for International Settlements is not the international supervisor! ... In sum, there is no international supervisor that has the same knowledge, presence, and clout as does the national supervisor in its own domain. No sovereign national will invite constant oversight of its financial institutions by a supranational entity, nor give to that entity the right to close some of them.¹³

Mann proposes that the private sector be induced to fill the gap in normal times as a means for mitigating moral hazard in the international credit market and helping avoid crises. Indeed, insurance companies have recently begun to offer a few products similar to the ones she proposes, but so far, demand has been weak.

Policy Review

Over the past few years, official circles and private think-tanks have floated various proposals for mitigating the moral hazard faced by the IMF in its role as lender of last resort. Many of these proposals touch on private sector involvement. This section presents a critical review of policies recommended by the G-7, the United Nations, and the private sector.

G-7 Doctrine

The official G-7 doctrine on private sector involvement in the workout of emerging market debt crises is spelled out in the Report of the G-7 Finance Ministers of July 2001.¹⁴ This doctrine evolved in the late 1990s in response to the massive bail-outs granted during the Mexican and Asian crises, which were criticized largely on moral hazard grounds. The G-7 document thus goes directly to the point by emphasizing the need for the private sector to become engaged in order to “avoid creating expectations that private creditors and investors will be protected from losses.”

¹³ Mann (1999), op. cit.

¹⁴ G-7 Finance Ministers and Central Bank Governors. July 7, 2001. *Strengthening the International Financial System and the Multilateral Development Banks*. Rome.

The G-7 report correctly points out that the debtor country's financing gap should be reduced to the greatest extent possible by means of policy changes, and filled by an appropriate combination of official and private sector money. Official money cannot, and should not, be the only means for resolving a debt crisis.

The G-7 recommends strengthening market discipline by making creditors bear the consequences of the risks they take. This will reduce moral hazard. It argues that agreements between debtors and creditors should be reached that are based on cooperative, negotiated, and voluntary efforts, employing a case-by-case approach, and led, if necessary, by the IMF. Principles and tools should be derived from case studies. They should promote transparency and give clear guidance to officials resolving crises.

This doctrine does not contemplate rigid rules. For the private sector, such rules would have little meaning because there is no international authority able to enforce them, and the private sector would have strong incentives to avoid being caught. Rigid rules for the official sector would also be inappropriate because flexibility is needed to make crisis management efficient. Workouts should serve the needs of each individual case; again, we see the convenience of constructive ambiguity.

Provision of official money should be geared toward supporting market-based solutions, inducing cooperative attitudes by the debtor country, private provision of new money, maintenance of exposure, and willingness to restructure obligations. No private creditors should be regarded as inherently privileged. Countries must negotiate in good faith, and negotiations must not undermine the obligation of countries to meet their debts in full and on time. Strategic (opportunistic) defaults must incur a cost. Creditor rights should be safeguarded through IMF authorization to lend into arrears.

The G-7 report deems rescue packages inadvisable; they should be considered only as an exception requiring extensive justification on the basis of a sudden, disruptive loss of confidence. They should be applied to cases where difficulties are expected to go away early, where efforts to secure participation by private investors have been made, and where there is a risk of contagion. Therefore, help is extended more freely to large, systemically and politically important countries than to smaller ones. In other words, the "too big to fail doctrine" lingers on, increasing moral hazard in the domestic markets of favored countries and through-

out the international financial system. It is also costly and unfair to citizens, especially the poor, in smaller countries, who are hurt by financial crises, that are often the result of contagion, rather than of their country's own doing.

The doctrine adopted by the G-7 addresses private creditors' concerns about the Paris Club by calling for increased coordination between the IMF and the Paris Club to assess the scope of participation and provide for comparable treatment of private creditors and Paris Club members in debt restructuring cases.

United Nations Initiatives

1. The Secretary-General's Report

In January 2001, the United Nations published its *Report of the Secretary-General to the Preparatory Committee for the Conference on Financing for Development*.¹⁵ This report mentions some basic principles related to moral hazard in international finance without going into details: strengthening transparency of financial markets, improving regulations to limit the potentially destabilizing impact of highly leveraged financial institutions, improving debt management by debtor countries as a means to avoid over-borrowing, improving communication between debtors and creditors, using collective action clauses, equitable sharing of the cost of restructuring among all relevant creditors, and Paris Club comparability.

The report also recommends exploring additional "last resort" mechanisms to be added to the international community's tool-kit. However, in seeking and assessing such mechanisms, moral hazard considerations should be at the top of the list. An effective mechanism design requires careful prior study, and although it is not suggested in the report, coordination with the IMF is advisable.

The Secretary-General's Report sketches out a mediation mechanism to be invoked by a country already engaged in discussions with the IMF and other international financial institutions, aimed at achieving a "simultaneous, fair and full treatment of all of a country's foreign debt obligations, along with the provision of the required new funds by the international communi-

¹⁵ United Nations. January 2000. *Report of the Secretary-General to the Preparatory Committee for the High-level International Intergovernmental Event on Financing for Development*. New York.

ty or other creditors.” An independent mediator, assisted by the IMF and other experts, would act as a facilitator to speed up the resolution process and lower the cost to both creditors and debtors (a win-win situation). Mediation may not always bear fruit. While it can be quite useful in dealing with problems between debtors and creditors, the process proposed in the Report would be complex and risky for debtor countries.

- First, it tries to bring a huge, possibly difficult-to-convene crowd to one table under the assumption that all debts must be restructured, which is not always the case, and that a one-size-fits-all approach to the process can work, which doesn’t take into account the diversity of creditors.
- Second, the Report suggests the gathering together of committees to represent bank creditors, bondholders, the Paris Club, other bilateral official creditors, and the debtor government. Some of these committees, however, don’t exist (bondholders don’t form committees), and others are of limited relevance (bank creditor committees are not very efficient in dealing with short-term credit line problems).
- Third, Paris Club issues need to be addressed by ironing out general principles that ensure transparency and comparability; these are not issues that concern all creditors.
- Fourth, the debtor country would be facing an immense challenge: dealing with all its creditors simultaneously, in a negotiating process unlikely to lead to a speedy or fair outcome, but likely instead to put strong pressures on the debtor country. Not even a powerful and persuasive independent mediator or group of mediators would be likely to turn things around. Negotiations could be cumbersome and protracted, and may produce poor results. If faced with the prospect of such a complicated and risky process, creditors will rush to the exits to protect themselves, and debtors will find themselves painted into a corner.
- Fifth, this mechanism would further politicize workouts, making new loans more difficult to obtain.

2. The Zedillo Report

The 2001 Zedillo Report¹⁶ says little about moral hazard issues. It does endorse the need for Paris Club transparency and comparability, and it supports

¹⁶ United Nations. June 2001. *Report of the High-level Panel on Financing for Development*. New York.

collective action clauses permitting a qualified majority of bondholders to approve changes in their payment clauses. It recommends seeking a “new mechanism to mediate relations between debtor and creditor countries,” but does not expand on the proposal of the Secretary-General. It points to the need to enhance crisis prevention on the part of the IMF. It recommends that conditionality be “streamlined” to ensure that IMF demands on borrowing countries take into account the domestic authority’s capacity to implement them, and it advised that the IMF’s core mandate not be exceeded.

The Zedillo Report further recommends assessing and improving present arrangements for crisis resolution. These include both the IMF’s Supplementary Reserve Facility, designed to lend large sums at high interest rates for relatively short periods to countries in crisis, and the Contingent Credit Line, aimed at giving pre-approved countries the option to draw on emergency financing in the event of a crisis caused by contagion. However, the report fails to provide guidance that is more specific.

Market-based Solutions

The IMF must continue to play a key role in the international financial system. It is the only institution capable of coordinating large and immediate injections of credit when financial panics threaten to overwhelm countries and undermine global financial stability, trade, and growth. But as mentioned in Section II, its role as lender of last resort lacks the complement of a supranational supervisor. No country will give up the right to monitor and close down its own financial institutions. International standards are the most one can expect - for now. Even in the European Union, where great progress has been made in achieving integration, financial supervision still falls under national jurisdiction.

Investors should seek and developing countries should support the design of market instruments that reduce the occurrence and size of financial crises as a complement to official mechanisms. Mann¹⁷ proposes two such instruments: credit risk insurance and restructuring insurance. A creditor, knowing there will be no bail-out and interested in hedging risk, would purchase insurance for the assets it holds at a price based on default risk. When a financial crisis hits, the insured lenders would not abandon the insured borrower, at least not for the duration of the policy. And by slowing the race to the exits, the self-fulfilling nature

¹⁷ Op. cit.

of some financial crises could be contained. The herd mentality in the market could be altered by diversifying the exposure of market participants and by moving risk from those who fear it to those who manage it.

Recommendations

Moral hazard problems affect international financing for developing countries in two ways. First, asymmetric information hampers the borrower's ability to get credit, shrinking the flow of funds and making it more volatile. Second, the prospect of bail-out by an international lender of last resort leads domestic private sector borrowers to over-borrow and international investors to over-lend and under-monitor. This makes financial crises more likely to occur. Moral hazard can also increase if, in repeated play, creditors and debtors are totally or partially bailed out, and are thus spared the costs of their mistakes. Recommendations to contain moral hazard problems in external financing for developing countries therefore span both crisis prevention and crisis resolution. They involve debtor and creditor governments as well as the international financial institutions.

Preventive Measures

Measures to prevent crises help reduce the moral hazard faced by the IMF in relation to private creditors and national lenders of last resort by making IMF intervention unlikely to be required in the first place.

Sound policies. Debtor countries contribute to reducing moral hazard in international finance by applying appropriate foreign exchange and monetary policies, thus ensuring adequate risk pricing in private sector transactions.

Abundant information. Improving information flows throughout the financial system reduces uncertainty and thus alleviates the moral hazard that can cause financial instability. Uncertainty generates instability by making it hard for lenders to screen out bad credit risks¹⁸ and monitor borrowers. Instability, if left unchecked, may lead to a full-blown crisis.

18 The challenge in screening good credit risks from bad stems not from moral hazard, but from adverse selection, a separate asymmetric information problem that, like moral hazard, contributes to financial instability, the precursor to crisis. For an introduction to the role of both types of information asymmetry in financial collapses, see Mishkin, *op. cit.* Mishkin goes so far as to define financial instability as credit system impairment caused by shocks to the system that exacerbate information asymmetries. Any increase in uncertainty will comprise such a shock.

- Information must flow freely between lenders and borrowers. If creditors can effectively monitor debtors, then they are more likely to fund productive, rather than destabilizing, investment projects.
- Information must flow freely between the private sector and governments. Governments everywhere must augment their disclosure of macroeconomic policies, fiscal accounts, public sector borrowing requirements, contingent fiscal liabilities, cross-border capital flows, foreign indebtedness, and their degree of commitment to ongoing economic reforms.
- Information must flow freely from lenders and borrowers to the markets to enhance market surveillance.

No painless defaults. In order to contain moral hazard, the borrower and the creditor must bear the cost of default. Bail-outs increase moral hazard and should be avoided. The debtor country government must make a credible commitment not to bail out the private sector. Large corporate debtors that get into trouble must be allowed to fail and creditors to lose money. This sends a powerful message to the market and helps contain moral hazard throughout. It prevents financial crises, thus reducing the need for IMF intervention and minimizing its moral hazard. Crony lending to firms with ties to banks and politicians largely explains the financial crises that hit many emerging market economies. For example, in recent years, crony lending was a chief cause of crises in Thailand,¹⁹ Venezuela,²⁰ and Bolivia.²¹

Implicit guarantees by governments reduce a bank's incentives to monitor and liquidate poor quality projects and increase the pressure for bail-outs. Thus, they become self-fulfilling prophecies. While it is true that lenders don't rush to lend because they bet on the bail-out, it is also true that the prospect of a bail-out makes lenders less vigilant.

The building of trust. Debtor countries benefit from building stronger relationships with their creditors and international financial institutions in

19 Kali, Raja, Yupana Wiwattanakantang and Chutatong Charumilind. 2001. "Crony Capital? Corporate Debt Maturity in Thailand Before the Financial Crisis." Mimeo. University of Arkansas.

20 Krivoy, Ruth. 2000. *The Venezuelan Banking Crisis of 1994*. Washington, D.C: The Group of Thirty.

21 Trigo Loubière, Jacques. June, 2001. "The Crisis in the Bolivian Financial System: Causes and Solutions." Paper prepared for the conference sponsored by the Inter-American Development Bank and the Japan Center for International Finance. Washington, D.C.

normal times. Through so-called constructive engagement, relevant information can be disseminated, policies explained, and policy credibility built up. This helps reduce moral hazard inherent in lending and thus strengthens credit systems overall. It also facilitates early cooperative action in the event of a crisis. Internationally, the Capital Markets Consultative Group, which was set up by the IMF, is a step in the right direction, and there is room for new initiatives to flourish. Nationally, debtor countries will be well served individually by building up investor relations.

Effective prudential supervision in the debtor country. To keep in check the excessive risk-taking at both ends that may be induced by both the national and the international lender of last resort, debtor country governments need to supervise foreign borrowing by their domestic financial institutions and corporate sector, and lender governments need to keep an eye on domestic credit institutions' lending abroad. The banking system in developing countries will be more resilient with rules that limit their foreign exchange exposure and with liquidity rules requiring them to hold an appropriate level of liquid high-grade foreign assets whose market value will not be impaired by domestic financial or macroeconomic instability. Banks should be further required to hedge their associated foreign exchange risk exposure.

Banking crises occur in both developed and developing countries, but they are more painful in the latter. The US, with its strong economy overall, breezed through its savings and loan crisis in the late 1990s, whereas a similar crisis in a developing country would have been devastating, leading to major capital outflows. Such outflows easily turn into full-fledged macroeconomic crises that call for stringent adjustment programs. Keeping banks strong, important anywhere, is therefore especially important in developing countries. Well-capitalized and liquid banks not only prevent bank crises, but also make the entire economy less vulnerable to external shocks. This fact makes effective supervision in debtor countries especially important.

Effective regulation in the debtor country. The domestic private sector should not be allowed to over-borrow. In addition to sound foreign exchange and monetary policies, the debtor country government must closely monitor the health and risk exposure of the financial system, and avoid excessive foreign borrowing by banks and corporations. Rules and taxes

applied to this end need to be closely monitored, but exchange controls should be avoided because they are likely to create distortions and induce corruption, especially if they are applied to stop capital outflows.

Effective prudential supervision in the creditor country. Developed countries must rein in imprudent risk-taking by their financial institutions, since these banks may gamble on a bail-out. Effective regulation of bank lending to highly leveraged institutions is especially crucial.

Conditionality. Conditionality in IMF lending is an effective, albeit unpleasant and painful incentive for promoting adequate credit supervision on the part of governments. Governments need to solve their own moral hazard problem by applying sound economic policies, supervising credit markets closely and refraining from bail-outs. Ones that fail to do so should lose access to the IMF's services as a lender of last resort, unless they are prepared to take corrective actions. However, as the Zedillo Report rightly says, a balance must be struck between conditionality and ownership. Adjustment programs must recognize what debtors can really commit themselves to enforcing.

Crisis Management

Bringing about orderly, fair solutions to external debt problems in developing countries through private sector involvement is one way to reduce the moral hazard inherent in international financial markets and exacerbated by the IMF's role as lender of last resort. This requires pro-active crisis management, limited funding by the international lender of last resort, skillful coordination, and negotiations conducted in good faith. Market mechanisms should help reduce the need for IMF bail-outs. Creditors' rights should be protected in order to make crisis resolution fair and balanced.

Early intervention. A crisis must be dealt with as early as possible. The IMF must move quickly, and governments must avoid waiting too long to approach the Fund in the event of instability. Governments that maintain a smooth relationship with the IMF in normal times can tackle a crisis more efficiently and create less noise in the market than those that do not, and this also paves the way for private sector cooperation.

Private sector involvement to resolve crises. A "pure" illiquidity problem would justify using only official funds to solve a crisis. Experience, however,

proves that there is never a pure illiquidity problem. Countries facing runs may be solvent, but they usually have weak fundamentals and serious policy shortcomings; this justifies involving private sector capital in funding the resolution.

Clear guidelines for private sector involvement. This paper has demonstrated the crucial role the private sector can play in reducing the moral hazard incurred by the IMF in its role as international lender of last resort. The IMF, however, must take care to establish clear guidelines for involving the private sector in order to reduce uncertainty and improve coordination, and thus help limit moral hazard. Moreover, these guidelines will reduce the potential for collective action problems inherent in private sector involvement, ie., the temptation private actors face to free ride on each other's actions in a crisis. Work on principles and guidelines for private sector involvement has already begun at the IMF and is a step in the right direction. Developing countries must become actively engaged in this discussion.

Early private sector involvement. If it is deemed necessary to help resolve the crisis, the private sector should be brought in early. If normality is not restored quickly, the crisis will worsen. But countries and the IMF must also avoid mobilizing private sector involvement unnecessarily by over-estimating the problem. Careful estimation of the financial gap is therefore crucial. Private sector involvement can be made more or less voluntary, depending on the nature of the debtor's problems. The key is to fill the gap as swiftly as possible and achieve a balance that restores confidence.

Market-based negotiations rather than rigid rules or unilateral actions. It is hard to determine *ex-ante* the most appropriate type of private sector involvement or to determine which claims should be excluded. Generally, however, all creditors holding the same class of claims should be treated equally.

Limited IMF intervention. The resources to be provided by the IMF as the international lender of last resort should be appropriate, but limited. IMF money plays a catalytic role and must be sized in accordance with the degree of insolvency or illiquidity of the particular debtor. Whereas, insufficient official funding may leave a financial gap that is too wide to be

covered by adjustment policies and make the burden on the debtor country unsustainable, excessive official funds add to the moral hazard problem. Conditionality in IMF lending plays the role of collateral in lender-of-last-resort lending and limits moral hazard.

Mediation. Mediation is helpful in preventing and dealing with financial crises. Historically, the IMF has acted as a mediator when international financial crises loomed or occurred. However, since the IMF is dominated by the G-7, some critics consider it therefore biased and conclude that a neutral mediating institution should be created. Such a move would be risky. First, officially sponsored mediations can backfire. The process tends to get dragged out and become highly politicized, and that can scare creditors off before the parties have reached a deal. Second, a new institution may eventually face a similar problem of neutrality, if it falls under the dominance of the world's chief economic powers. Instead of creating a new institution, which may turn out to be a mirage in our thirst for neutrality, we should improve the mediation mechanism used by the IMF. Buira²² proposes changes to IMF governance that would give non-G-7 countries greater clout and help turn the Fund into a more neutral mediator. His proposal is difficult, but feasible, and is less likely to disappoint in the end.

Cautious use of Collective Action Clauses (CACs). CACs may aid in an orderly workout by organizing creditors, but they are neither a miracle cure nor indispensable for successful restructuring. Debtor countries may benefit by including CACs in future bond contracts and should negotiate this with their creditors.

Standstills. Standstills may be necessary to prevent a period of turmoil from turning into a full-blown crisis, or to prevent the risk of outright default once a crisis has begun. They serve to prevent a grab race for assets by creditors that hurts not only the debtor but also the creditors as a group. Standstills can be beneficial, but only if the debtor country also determines its policies. Debtor countries imposing standstills must apply controls on capital movements to enforce the standstill on private sector payments, and

²² Buira, Ariel. September, 2001. "Reforming the Governance of the Bretton Woods Institutions." Paper presented at the G-24 Workshop "Financing for Development." New York.

such controls are often very costly to the economy. Standstills and controls must be used cautiously; otherwise, they may worsen problems for the debtor and spread contagion to other developing countries deemed to be in similar circumstances.

IMF lending into arrears. IMF lending into arrears is equivalent to an officially sanctioned standstill and is a step in the right direction. Further enhancing IMF powers to sanction a standstill at the request of the borrower should be analyzed, and the potential risk of disruption caused by governments rushing to request such a standstill must be avoided.

An International Bankruptcy Court. Since governments enjoy immunity, can hide their assets, and are aware that no well-defined bankruptcy procedure is available to creditors, an International Bankruptcy Court would be of limited use. Private sector debtors must be subject to national bankruptcy courts.

Proper cost allocation. Those who make mistakes must bear the cost. Loans from lenders of last resort disbursed at penalty rates follow this rule. Not rescuing large international investors because of the risk of a run on a systemically important debtor is crucial to containing moral hazard.

Revamping Paris Club rules. These rules should be made more transparent and predictable to help coordinate creditors at the time of a work-out. However, private creditors' complaints about the seniority of Paris Club claims seem questionable, based on experience in loan restructuring.

Private sector insurance products. These products, which may include credit-risk insurance or restructuring insurance, would help stabilize the international financial system and, if well designed, would contain moral hazard. Not all borrowers would offer insurance, and not all lenders would buy it, but for those who did, the insured lender would not abandon the insured borrower when a financial crisis hit, at least not for the duration of the policy.

Global Economic Governance: Conditions and Opportunities for an Enhanced Role for the United Nations

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Abstract

This paper analyses the conditions and opportunities for an enhanced role for the United Nations (UN) in global economic governance. The paper starts out questioning some established notions about developing country interests in terms of UN and global economic governance, and advocates a careful scrutiny of traditional agendas to that effect. It goes on to present the limited UN role to date in this area, and discusses reasons for this, such as Cold War-related East-West polarisation, the UN governing structure (one nation, one vote) and the iron law of global politics, which implies that leading nations want issues of strategic interest handled by institutions that they control, and also mismatches between governing structure and the present operative tasks of the UN. The paper then goes on to explore a range of features that could open up new opportunities for the UN in global economic governance: increased (post Cold War) consensus on global economy dynamics, concern about globalisation and the global democratic deficit, enhanced demand for global public goods, UN reforms making the UN a more attractive co-operating partner (e.g., for the WTO and Bretton Woods Institutions), and increased incentives for private sector engagement with the UN. To capitalize on such opportunities, a number of conditions for a stronger UN presence in the global economy must be taken seriously: respect for the political laws of gravity; the comparative advantage of the UN in terms of the relations between governing structure and operative functions, and the urgent need to continue UN reform efforts. Finally, the paper discusses a range of more specific proposals in the context of the up-coming FfD conference: how to deepen the UN interface with the more powerful players in global economic governance; the proposal to establish an International Tax Organisation (ITO);

the concept of a Globalisation Summit and a Globalisation Council; potential roles for the UN in global monitoring efforts; and ways and means to strengthen the agenda-setting and forum roles of the UN.

Introduction

The main goal of this paper is to analyse conditions and opportunities for an enhanced role for the United Nations in global economic governance. Its starting point is the striking discrepancy between the past and present expectations of the UN in this area, and the limited niche that the organisation has managed to carve out for itself. The paper will be structured around the following issues and questions:

- The relations between the interests of developing countries and the strengthening of the United Nations.
- The present (limited) role of the UN in global economic governance; the division of labour that has emerged with the WTO and the Bretton Woods organisations as well as the organisation's ability to cope with new challenges in the wake of globalisation.
- The (structural, historical and political) reasons why the ambitions of the founding fathers of the UN in terms of global economic governance are far from being fulfilled.
- Conditions for a more comprehensive and assertive role of the UN in global economic governance.
- Why there are now new opportunities and an enhanced scope of action with respect to UN involvement in global economic and political affairs.
- Specific challenges and recommendations in the context of the upcoming UN High-Level Conference on Financing for Development, reflecting the analysis in the five previous chapters.

Developing Countries and the Strengthening of the United Nations

An introductory reflection is warranted on the relationship between the interests of developing countries and the relative position of the UN in global economic governance – both because of the theme of the 2001 G-24 work-

shop and because to a large extent it is the developing countries that have argued the case for holding the FfD conference. It is commonly assumed that the more tasks, funds and ‘power’ that is given to the UN, the better for the general interest of developing countries. This is based on the rationale that the representative one nation, one vote structure of voting rights in the UN provides the developing world with a solid and stable majority. The notion is also supported by political history in that the UN over the past five decades has been the key forum for formulating and presenting the demands of developing countries towards the broader global community.

While it would thus be tempting to equate maximising funds and tasks for the UN with maximising the power and interests of developing countries, this paper will provide some nuances to such a notion. These nuances are best summarised in the following three paragraphs, which will be further explored in the chapter on *conditions* for a stronger UN:

- If sufficient attention is paid to the relationship between the governing structure of the UN and the functions taken care of by the organisation, as well as to the comparative edge of the UN versus other global institutions, the UN will become stronger and more effective. In this sense, the stronger the UN, the better it will be able to care for the interests of developing countries.
- On the other hand, if large parts of the available (and scarce) political energy for multilateral cooperation are invested in a struggle to maximise the mandates, tasks and funding of the different parts of the UN system, irrespective of the factors just introduced above, there is a real danger that the only thing that will be strengthened is the notion of the UN as an unwieldy and bureaucratic paper tiger. This would also probably hurt, as a negative side-effect, the legitimate struggle for fairer voting rules and more influence in the major global economic institutions.
- Following from this, it might then well be that both developing countries and the UN in certain cases will be better served by raising issues in and delegating tasks to other global institutions. In other words, developing country support for a stronger UN should not imply putting all eggs in one basket. It has always been tempting for governments (in the North as well as in the South) to burden the UN with tasks as a substitute for badly needed domestic or regional action. The result is less UN potency in the areas

where it enjoys a real competitive edge. Experience suggests, furthermore, that developing countries may obtain more through fighting out given battles in institutional settings with less favourable voting rules – but in arenas where the big economic powers have a more real stake and interest.

The Present Position of the UN in Global Economic Governance

In assessing the present role of the UN in global economic governance, much depends on your initial baseline, or, in other words, what you assess it against. Measured strictly against the rhetoric of state leaders 50 years ago and even today, the UN must be considered a great failure. This would not be fair nor particularly relevant, though, as we will point out below. Still, however, there is every indication that the UN also does not deliver when tested in more relevant settings. In what follows, we provide some of the main indicators of the modest role (at best) that the UN plays in present patterns of global economic governance.

In the mobilisation and administration of financial resources for development. Notwithstanding the high attention to development assistance in UN forums, and the large number of UN agencies involved in executing aid, the relative role of the UN in this key area has always been modest and has also been reduced over the past decade. The key “competitors” to the UN are i) the World Bank and the regional development banks; ii) bilateral governments and the European Commission; and iii) non-governmental organisations. World Bank lending for what the UN terms human development increased ten-fold between 1985 and 1995, at a time when funding for UN agencies started to dry out.¹ The overall percentage of multilateral versus bilateral ODA by OECD countries went down in the 1990s, most probably with the UN as the bigger loser among the multilaterals. NGOs, however, have grown ever more vocal development players over the decades, giving them not only superior media coverage (to that of the UN) but also greatly enhanced financial clout.²

1 Bergesen and Lunde, 1999, page 131.

2 See Irfan Ul Haque’s paper for the Vienna 2000 G-24 workshop for a critical review on the role of NGOs in global governance as seen from a developing country point of view.

The awareness-raising, agenda-setting and convening power in support of development. This is an area that has generally been seen as an important one for the UN, and it is often termed the normative power of the United Nations. While not neglecting the contribution of, e.g., the various global UN conferences, the UN is critically challenged in this area by a range of tough competitors. Partly in response to critics, the World Bank has gradually taken on a very broad agenda-setting function, bolstered by a research and policy analysis capacity that makes similar facilities of UN bodies pale in significance. Its vocal role in the environment and development debate is one example, its initiation of the Comprehensive Development Framework (CDF) another. Other challenges in the same area are posed by NGOs, the European Commission, bilaterals or groups of bilateral donor countries and private sector-related initiatives such as the World Economic Forum in Davos.

The global trade agenda. Ever since the proposed International Trade Organisation (ITO) had to give way to GATT (General Agreement on Tariffs and Trade) in the early post-war world, the UN never really managed to grasp a vocal role in the regional and global governance of trade flows. *Trade and development* has long been a meaningful niche for the UN, but with some exceptions in functional areas that complement GATT/WTO, the UN has played a rather marginal role in global trade discourses.

International financial cooperation and debt issues. Despite numerous efforts by developing countries to put debt and other development finance issues on the UN agenda, they remain squarely under the purview of the Bretton Woods Institutions and related forums controlled by public and private creditor bodies. Financial cooperation in a wider sense also brings in more informal bodies such as that of the G-7, and also recently the G-20 with representatives of both industrialised and developing countries. Even in the latter case, the UN is virtually absent as a player in policy areas of great interest to developing countries.

The new and emerging globalisation and anti-globalisation agenda: Seattle, Prague, Washington, Gothenburg, Genoa. While there is little reason to envy the organisers of the recent globalisation-related summits, the flip side of the

coin is that these are the arenas that global citizens believe to be responsible for global economic governance. Accordingly, the virtual absence of protest at UN summits in New York and elsewhere just adds to the notion that the United Nations has been sidelined in global economic governance by organisations such as the Bretton Woods twins, the WTO, the EU and the G-7.³

Why the Picture Is Not That Bleak

The brief and consciously simplified survey just made indicates a very limited role of the United Nations in global economic governance. There is likely to be broad agreement behind the main thrust of this image. However, a number of features and developments serve to challenge this negative picture. They are summarised here for the sake of the argument, while the most dynamic ones are further elaborated in the chapter below on the new opportunities and enhanced scope of action for the UN.

Increasing attention to the ‘global democratic deficit.’ Another important dimension of the heated struggle over globalisation is the growing demand for legitimacy and representativeness in the decision-making structures of global economic governance. Joseph Nye’s *Foreign Affairs* article on “Globalisation’s Democratic Deficit” is just one among a rich variety of voices asking for a stronger voice for the voiceless.⁴ This represents a unique opportunity for the UN in its relationship both to the existing strong institutions and to emerging new ones in the response to globalisation, and is highly relevant in the context of the upcoming FfD conference. Also, however, it is an opportunity easily squandered, an issue to which we will return towards the end of this paper.

The ripening fruits of UN reform. There is no denying the overall primacy of bodies such as the World Bank in mobilising resources for development. There are signs, however, that the best reformers in the United Nations’ family are managing to turn the negative trend and mobilise sizeable volumes of funding for key development goals. The World Health Organi-

3 The protests at the 2000 UNCTAD X conference in Bangkok were a certain exception, though, as the Italian government’s fear of large-scale protests at the FAO World Food Summit in the fall of 2001 clearly showed.

4 *Foreign Affairs*, July/August 2001, pp. 2-6.

sation (WHO) is a case in point. Through internal reforms and effective outreach to and partnerships with governments, NGOs and the private sector, available funds are increasing to handle challenges such as AIDS and the vaccination of the world's children. Importantly, resource mobilisation is done to a large extent by brandishing the normative, agenda-setting role of the WHO, while the actual implementation is taken care of either by other stakeholders or in partnership with them.

Stronger outreach to the key global players. It is difficult to distinguish rhetoric from real content in general statements about the global potency of the UN General Assembly, ECOSOC and related institutions. This also holds to some extent for the preparatory documents for the FfD conference. Still, we will argue that there is a positive trend in terms of making these key UN institutions more relevant for global economic governance. Part of the reason is the continuous UN reform efforts overseen by the Secretary-General, which are aiming not least at improving internal communication and coordination between the different parts of the system. Then add the (related) significant expansions in informal as well as formal consultation with the Bretton Woods Institutions, of which the preparations for the FfD conference stand out to this author as a key achievement (see below). Although controversial and still in its infancy, we also believe that the UN Global Compact represents a promising approach to making the UN more relevant to the emerging discourse on corporate social responsibility (CSR) and the private sector response to globalisation.

Why Still a Limited Role for the UN

*Seldom before in the history of mankind has an organisation been created with greater opportunity to save mankind than has been given to the Economic and Social Council under the Charter of the United Nations.*⁵

This is not the place to dig deep into causal factors behind the limited role of the UN in global economic governance. Some key features will be presented, though, because we consider them central to the discourse on where the UN could or should go from here. The following 1958 quote

⁵ Asher, 1958, page 289; quoted in Lunde, 2000, page 8. It is a quote from the US ambassador to the UN when he addressed the inaugural session of ECOSOC in 1945.

from Robert Asher, a prime expert on the development of global institutions from the Second World War and onwards, provides us with a sober starting point, reflecting the clash of immediate post-war optimism with the *real-politik* of the Cold War era:

The most notable multilateral initiatives of the last decade, moreover, have, with a few exceptions, been taken outside the UN framework. In the economic field, these include three concomitants of the Marshal Plan, the Organisation for European Economic Cooperation, the European Payments Union and the European Productivity Agency; three associations involving Benelux, France, Germany and Italy, the European Economic Community (common market) two other European groupings, the proposed free trade area, and the proposed Nordic Customs Union; and a peculiar arrangement that includes participants from several continents and has both multilateral and bilateral features, the Colombo plan.⁶

To guide our further discussion on conditions and opportunities for the UN, we hereby summarise some key reasons for the limited role of the UN in global economic governance:

The Cold War. The onset of the Cold War in the late 1940s not only hit the UN's mandate in peace and security, but in global economic affairs as well. For many decades the polarisation between the capitalist and socialist/communist worlds respectively served to paralyse the ability of the UN to develop both capacity, norms and policy for the emerging post-war global economy. Significantly, with the symbol-rich fall of the Berlin Wall in 1989 this factor is no longer at work, which provides promising opportunities to retain the original UN mandates in this area.

The iron law of global politics. The big economic players, as well as the OECD region collectively, wanted and still want to handle important policy issues in policy settings where they can maximise their own vote and influence. The UN, with its particular decision-making machinery, never became the favoured option of the industrialised countries. They voted with their feet in favour of the Bretton Woods Institutions and GATT where global coordination was needed, and various regional schemes (outside of the UN) as il-

⁶ Asher, 1958, pp. 289-90.

lustrated in the Asher quote above where flexible regional coordination was seen to be required. This basic iron law of global politics is highly valid today, while the withering away of the Cold War-dominated confrontation on global economic governance may contribute to softening somewhat the stance of even the bigger economic players in ways favourable to the UN (see the chapter on new opportunities for the UN below).

Ill-designed for operative functions? As already touched on, even in the more limited area of resource mobilisation for development, including operative aspects of development cooperation, the relative niche of the UN has remained modest at best. Even if not always reflected in rhetoric, the actions of the main donors over the decades have meant priority to the World Bank, bilateral agencies, the EU and NGOs at the expense of UN bodies. The causal patterns behind this are complex. In a recent book, we argue that a key reason is that the representative nature of UN decision-making is well designed for norm-creating functions but ill-designed for the demands of the operative development functions.⁷ This is controversial, and it is demanding to prove such causal patterns. We believe, however, that it is a relatively robust explanation of why the industrialised countries have not wanted the UN to attain a central role in resource mobilisation for development.

New Opportunities and an Enhanced Scope of Action for the UN

The lessons of history, structural/organisational factors and the ‘iron law of global politics’ should be factored into any assessment of future options for the UN. They certainly serve to limit the scope of action as compared, e.g., to the ambitions of the founding fathers of the UN, and to those voiced over the decades by developing country representatives in UN contexts as well as increasingly by radical NGOs. Still, a number of developments, many of which are related to globalisation, may contribute to strengthening the overall impact of the United Nations in global economic governance.

⁷ Bergesen and Lunde (1999). *Dinosaurs or Dynamos? The United Nations and the World Bank at the Turn of the Century*, Earthscan, London.

Increased consensus. First, as already mentioned, the end of the Cold War has gradually forged UN member countries closer in terms of basic politico-economic outlook. Few countries now believe that the state should be the main economic actor in a given country at the expense of private sector entities, and few argue against the need to take account of market forces, a dominant factor in the global economy. This is not to say that there is *consensus*, for instance, on the more specific role of market forces versus government regulation, both domestically and in a global context. Far from it, as shown by the recent clashes over globalisation. But the gulf between major groups of countries has definitely been narrowed. In the context of this paper, the significance of these developments is that they remove what has probably been the key industrialised country argument against the UN as a forum for serious discussion on global economic issues.

Globalisation, for and against. Globalisation, the vocal protests against globalisation and the strengthened notion of a global democratic deficit is rapidly increasing the demand for forums that can provide legitimacy to global economic governance. It has moved key players such as WTO, the World Bank and IMF into serious reflection as to how their deliberations can be made more transparent, representative and sensitive to the interests of developing countries. With a number of conditions fulfilled (see below), this search for global legitimacy could soon develop into a window of opportunity concerning a more assertive role for the United Nations.

Enhanced demand for global public goods. Various features of globalisation also serve to strengthen the sense of interdependence between countries and regions needed to tackle public goods-related challenges. Many of them go beyond both the reach of the UN and global economic governance more specifically. However, most take on economic and financial dimensions of high relevance to the UN, including climate change and other environmental threats, the fight against the AIDS pandemic and other global diseases, corruption and other economic crime, to mention just a few. In tandem with the push that the UN could get from the prime globalisation impact just mentioned, the interdependence/global public goods factor may then also serve to strengthen the role of the UN in global economic governance.

The UN as a more attractive co-operating partner. In a more narrow institutional sense, recent anti-globalisation turbulence is likely to have provided the global financial and trade institutions with stronger incentives to co-operate with relevant elements of the UN system. Apart from an already increasing flow of consultation between Washington, Geneva and New York, it is too early to say what this can lead to in terms of actually strengthening the role of the UN, and by implication the interests of developing countries. But these deepened incentives definitely represent an opportunity for the UN and its member countries to exploit. This applies both in terms of the fundamental agendas of bodies such as the Bretton Woods twins and the WTO, and more specifically where for instance OECD-related initiatives are stumbling at least partly due to lack of global legitimacy. The ill-fated Multilateral Investment Agreement is a case in point, while the recent effort to arrest the proliferation of tax havens has run into similar objections from developing countries.

Private sector incentives for engaging with the UN. Many find it ironic that it is mainly the global *public* institutions such as the WTO, the World Bank, the IMF, the EU and the G-7 that have become the victims and enemy images of the anti-globalisation crusade. What then about *the private sector*, the entities that squeeze out the bulk of the profit from the ever increasing pace of global transactions? The answer is that multinational companies are already in the limelight, to the extent that most major companies are in the process of writing up policies on corporate social responsibility (CSR). There are reasons to believe that the focus of global protest will shift further in the direction of companies rather than “the global public sector.” Overall, this creates incentives for companies to seek cooperation with “legitimacy providers” such as the UN. Many corporate actors may even find themselves lobbying for further multilateral regulations in the global market place, in order to become less vulnerable to anarchic and unpredictable NGO campaigns. The UN should definitely brace itself for future demands for more level playing fields in a global CSR context. A tiny but promising start to this effect is provided by the UN Global Compact.

Conditions for a more comprehensive and assertive role of the UN

Change is already in the air with respect to making the UN a more relevant player in global economic governance. The preparatory process towards the 2002 UN Financing for Development Conference is itself a case in point, and not as prosaic as it may seem at first glance. Involving the staff of the Bretton Woods Institutions as deeply as has been the case in the write-up of the key documents for the conference would probably have been (mutually) unthinkable ten years ago. Critics may well warn that the institutional interests of the UN and the political interests of developing countries are being sold out in the process. Without being in the position to pass an overall judgement on this, we are tempted to argue that the latter would be a short-sighted and superficial conclusion.

There is still a long way to go, though, until the various parts of the UN are prepared to capitalise on the windows of opportunity just presented. Again in very brief terms to save space, the following are conditions that should be met in order to realise a more comprehensive and assertive role of the UN in global economic governance.

Respecting the laws of gravity. First, many attempts to strengthen the UN have failed due to unwillingness to accept the basic political laws of gravity in global economic affairs. Given the one nation, one vote decision-making structure of the UN, there will always be clear limits as to what kind of issues the large economic powers will bring to the UN table in New York or elsewhere. Along another vein, respecting these laws of gravity also implies that the ‘body language’ of the UN on global economic matters should reflect both solid world class competence and a political content that does not differ systematically from that which is spoken in most capitals around the world. Also here we are tempted to give the preparatory documents for the FfD Conference high marks. While some have questioned the relevance of addressing domestic resource mobilisation (in developing countries) in the FfD agenda, we judge the handling of this issue as an important sign that developed and developing countries are on speaking terms.⁸ A lot of time

⁸ See Irfan ul Haque, 2001, ‘*Whither FfD?*’ (unpublished memo), for a critique of the FfD preparatory process in general on one hand, and a focus on domestic resource mobilisation on the other.

and political energy have been wasted in the past on sterile confrontations where rich countries blamed internal deficiency for the ensuing poverty, while poor countries blamed external forces in the global economy. With domestic resource mobilisation squarely on the agenda, developing countries have a more robust platform from which to address deficiencies in industrialised country responses to their demands.

Governing structure and normative versus operative functions. In pondering on how to strengthen the UN in our context, it remains crucial to reflect where its comparative edges are, and what mandates and tasks are best handled by others. For any large international organisation there is a relationship between its governance structure on one hand and the functions that it is best placed to handle on the other. While this concern is reflected in the preparatory documents for this conference, the documents also, unfortunately, echo a rhetoric that underplays the tensions and trade-offs involved in maximising representativeness on one hand and effectiveness on the other.

This is not the place to pass structure/function judgements on the totality of the complex UN organisation or on the division of labour between the UN and other bodies based on this logic. A few key observations, however, deserve to be mentioned. First, the uniquely representative structure of the UN implies comparative advantages with respect to functions primarily in the normative area (agenda-setting, global dialogue forum, norm creation, standard-setting, monitoring), while other global and regional bodies may be better placed to handle strictly operative functions e.g., in the area of support for development (policy advice, finance, aid implementation). This logic should by no means be applied in a strait-jacket fashion; the world is far too complex for that. Rather, it should be used as a testing ground to sound out in which of the new and emerging challenges in global economic governance UN agencies may make a positive difference, and in what areas various other institutions enjoy a comparative edge.

The process towards the FfD conference provides many opportunities to reflect on institutional division of labour in the perspective just offered. One general recommendation would be to seek to make the relevant UN bodies more effective (or create new ones in exceptional cases) in terms of

handling broad, global, normative functions, while delegating the actual implementation (most often at domestic levels) to other players. The above WHO example illustrates this logic: In our view, the WHO has succeeded recently by focussing on global advocacy in a flexible way that has both resulted in resource mobilisation and stimulated and catalysed action by governments, NGOs and even private sector entities such as the pharmaceuticals industry. Whether or not this leads to an enhanced WHO role in the implementation of aid projects should at best be a secondary (if at all a) concern from a developing country point of view.

A new boost to UN reform. Capitalising on the globalisation opportunities and rising to the challenges posed in the context of the FfD conference, in our view, demands that more political energy be put into UN reform efforts. The thrust of many FfD proposals that imply enhanced powers to the UN would bring policy-makers in a wide range of both public and private institutions much closer into partnership with UN forums. This holds not least for the proposals to make informal but important policy forums (G-7, G-20, the Financial Stability Forum) anchor their mandates and decisions within a more representative structure like that of the UN. Such a process of consultation will demand much of these more exclusive forums, but the challenge need not be smaller for the well-established but often impenetrable (for outsiders) decision-making procedures of UN bodies. This is not the place to analyse in detail how ECOSOC and the General Assembly need to be changed to attract and stimulate real dialogue with the key decision-makers in the global economy. Still the challenge can be raised, and the importance of getting the job done can be stressed.

Permit one (admittedly superficial) example to illustrate what it may take to transform FfD proposals from words to action in a UN context. Engaging the private sector is seen as a growing challenge in order to enhance the global economy relevance of the UN. The resistance within parts of the UN membership against the UN Global Compact, and the failure to create a really tempting opt-in for the private sector in the FfD preparatory process, are signs to this author of a tenacity of old structures that inhibit reforms needed to move the UN further in global economic governance.

Specific Challenges and Recommendations: The FfD Conference

Both the Secretary-General's Report and the Zedillo Report contain a number of proposals with important (potential) implications for the role of the UN in global economic governance. Reflecting our initial discussion of the interests of developing countries and the strengthening of the UN, the following could form a relevant context in which to judge the more specific FfD-related institutional opportunities for the UN:

- Proposals that concern how the interests of developing countries can be pursued in the present global financial- and trade architecture. This applies to substantive political proposals as well as proposals for organisational changes, e.g., to enhance the representation of developing countries in bodies such as the IMF, the World Bank and the WTO.⁹
- Proposals that concern how institutions where developing countries have a strong voice (in particular the UN) can be brought into a stronger interface and consultation (and co-ordination) with more exclusive institutions and forums, such as the G-7, the Financial Stability Forum and the major global finance and trade bodies just mentioned.
- Proposals to revise and strengthen the mandate of existing UN organisations in order to have a greater UN (and by implication developing country) impact on global economic affairs, and proposals to set up new institutions or meeting places either directly under the auspices of the UN Secretary-General or with more informal (though real) ties with the UN.

There are grey areas between these three basic approaches, as witnessed in many of the proposals emerging in the FfD preparatory process. Also, these approaches are by no means seen as mutually exclusive; developing countries should pursue all three simultaneously – in the FfD process as well as beyond the March 2002 conference. At the same time, though, they should be distinct enough to provide policy guidance and a certain basis for setting priorities.

⁹ See Ariel Buira's paper on this issue for the 2001 G-24 workshop. Consult also the work on the IDRC-funded project on Improving Governance in Global Financial Institutions.

Supporting Developing Country Interests within the Existing Architecture

As a rule, it is likely to be futile to aim at moving key IMF, World Bank or WTO mandates over to the UN. This reflects the point made above about respecting the laws of gravity in global governance – cynical as that may be. The same probably applies to demands for radical, abrupt shifts in voting patterns in the same institutions, which could easily turn out to be detrimental to developing countries should they contribute to de-legitimising or otherwise blocking the workings of these institutions. Even if skewed towards the interests of the industrialised world, the present global governance structure is itself vulnerable to forces of bilateralism and unilateralism as well as outright anarchy. This holds not least in the area of international trade, where a dismantling of the WTO could imply global protectionist anarchy with the major trading powers dictating the rules of the game.

These initial reservations notwithstanding, there are many (less confrontational) ways in which developing countries can gain from advocating governance changes, including participation, representation, transparency and accountability in bodies such as the Bretton Woods twins and the WTO. As this subject is covered by other G-24 workshop contributors, suffice it here to reiterate the potential scope of action with respect to such reforms in the wake of recent anti-globalisation protests. Efforts should certainly be made to capitalise on this new “global democratic deficit” dynamic within the context of the FfD conference, while reflecting the futility of aiming to let the FfD dictate specific changes in, e.g., the voting structures of other organisations.

UN Interface with the Global Financial Architecture

Many of the most promising avenues for strengthening the role of the UN come under this category, be they formal or informal. As already mentioned, the comprehensive involvement of the IMF and the World Bank in the preparations for the FfD conference represents an informal effort to this effect not least in the manner of developing personal as well as institutionalised networks between the different institutions. Part of

the reason for the relative alienation of UN bodies from the arenas of world financial power may be found in the clash in cultures between New York and Washington, rather than fundamental political differences. The FfD preparatory process has already proved to be bridge-building in this respect, as exemplified by G-77 participation in the September 2001 G-24 workshop and the scheduled meeting between the two groups in Philadelphia. Further efforts should be made to carry this momentum through the final prep-coms and into the 2002 FfD conference itself.

How, then, can the new “global democratic deficit-dynamic” be applied to create innovative buy-ins for the UN into hitherto more or less exclusive domains dominated by the big powers? How can the attractiveness of the UN as a new source of legitimacy in global economic affairs be enhanced with a particular view to ensuring developing country participation? The preparatory documents address this challenge up to a point, while more work has to be done to flesh out the strategies and specific proposals required to visualise the potential of this approach.

- One practical task would be for the UN Secretariat to map all the upcoming high-level summits and events of relevance to global economic governance, and then to reflect on how cases can be developed for links to be created between those events and relevant UN institutions.
- Another practical effort would be to review and reassess all the cooperative arrangements that already exist between the UN and both formal and informal big players in global economic governance. Many of these agreements are either obsolete or sleeping, but a fresh look is definitely warranted given the new globalisation-inspired topicality of the issue at hand.
- More fundamentally, a review is probably also called for as to how the UN can be made more relevant and attractive to those who are running the big global governance events. What changes and adaptations are needed in the workings of ECOSOC and the General Assembly, in order for the G-7, for example, to engineer a creative opt-in to enhance the legitimacy of their annual summits? Such a review will probably demand much both of the G-77 member states, which have invested substantial political energy in the present UN set-ups, and of the industrialised countries, many of which are sitting on both sides of the table in this context.

The UN and the Case for Institutional Change

The political substance of the FfD documents implies a range of challenges for the existing architecture for global economic governance. In addition, there are also proposals for more radical institutional changes, including that of setting up new institutions to cope with emerging globalisation issues. What is the role of the UN in this picture, and what can be done to ensure that whatever institutional changes come out of the FfD 2002 conference will reflect a strengthened UN?

Resistance against the establishment of new institutions is a central feature of the present globalisation discourse, pronounced at its most categorical by some of the world's major powers. The burden of evidence is thus on the shoulders of those proposing that new organisations be created to fill global governance gaps. Neither the UN nor its supporters needs to make any principled stand on this issue. Revised mandates and structures of existing institutions may well be more conducive to a stronger UN than the establishment of new bodies. Moreover, developing countries may, in given cases, be better served by lobbying institutional change in less representative settings beyond the UN, for the reasons given above. The proof of the pudding is in the eating. What should concern world governments in this context is to reach agreement on where the gaps are in present global economic governance, and then to seek consensus on how these gaps can best be filled. Below are some reflections, based on the logic of this paper, on the implications for the UN of the existing FfD proposals.

The proposal to set up an International Tax Organisation (ITO). The Zedillo Report makes a vocal case for a new International Tax Organisation (ITO). Global tax cooperation, or rather its absence, is presented as perhaps the most serious gap in present global governance structures, and an ITO would thus constitute a global public good once established. The prime question to developing countries is to what extent such an organisation would be in their interest, and secondly, whether, and if so, how the ITO should be linked with the UN system. This is not the place for a comprehensive survey of arguments for and against the ITO. Suffice it to assume that interests among developing countries are likely to differ, given the key priority accorded to tax incentives and tax competition by certain

groups of governments, e.g., among the small island states, and to warn that a new OECD-based player may emerge as the end-result, if industrialised countries are favourable, while developing countries are split and/or negative. The other question is thus related to the first: what about UN affiliations? Again, it is difficult and premature to give clear advice, not least because the specific mandate that governments are prepared to agree on may imply important directions with regard to institutional design. Suffice it to mention in this context that i) a global rather than regional institution would fare safer in the present discourse on globalisation; ii) that the IMF would be controversial for the same reasons; and iii) that a range of specialised agencies with functional, standard-setting mandates are often rated as the best achievers within the UN family, widely defined, and should be analysed as potential ITO precedents, e.g., the International Telecommunications Union, the International Maritime Organisation (IMO) and the World Intellectual Property Organisation (WIPO).

Globalisation Summit and Globalisation Council. The Zedillo Report mirrors previous proposals, for instance, for an Economic Security Council as a general way of enhancing global economic governance. It recommends the establishment of an institution to this effect to be preceded by a Globalisation Summit. The report then recommends consideration of a Globalisation Council that is separate from UN bodies such as ECOSOC and the General Assembly. While the Economic Security Council (proposed by the Commission on Global Governance) was assumed to be set up within the UN framework, the new proposal is unclear as to UN affiliations. While specific recommendations require analysis beyond the scope of this paper, we are tempted to warn against investing too much political energy in this field. In particular, there is the question of why one should by-pass the key UN institutions with respect to the Summit idea. There is a danger then that the globalisation momentum would be led into new institutions with an uncertain fate, while the existing global bodies (ECOSOC and the UN General Assembly) would be deprived of this unique opportunity and would risk appearing more and more obsolete in the global governance discourse. Therefore, our intuitive reaction to this proposal is to aim to force through sufficient changes in the relevant UN bodies as to make the UN the best qualified candidate for this crucial arena/forum function.

The UN and global monitoring. While improved global monitoring of global economic and financial affairs is advocated in both main FfD documents, there is little specific reference to the UN role in this important area. This is understandable, for instance, in the sense that it would be wrong-headed to challenge the key responsibility of the IMF in monitoring global capital markets. Thus, rather than challenging existing players with well established mandates, a case could be developed for the UN to get engaged in new and emerging discourses on global monitoring. One such area would be the monitoring of corporate performance in terms of social responsibility. The UN Global Compact presently has only a limited mandate of a mainly catalytic character. It is also wildly premature to establish UN-based monitoring regimes in this area today. But as the global dialogue on corporate social responsibility (CSR) matures, and with it the systems for indicators, reporting, monitoring and verification, demand may emerge – not least from the corporations themselves – for global standardisation and legitimacy in this field. A future role for the UN here would fit well with the notion of UN action in areas where there are demanding interfaces between the world of trade and finance on one hand, and broader social and environmental concerns on the other.

Strengthen the agenda-setting and forum role of the UN. The Secretary-General's FfD report in particular reflects on how the existing machinery of UN institutions can get more actively involved in global economic governance. We have already on several occasions touched on the need for these UN bodies to make themselves more attractive as partners in dialogue and policy development. More specifically, there is a case for looking closer at how the UN can sharpen its edge in terms of agenda-setting and its forum function in this area – or, more generally, the normative role of the UN. While present arrangements, for instance, for involving the Bretton Woods Institution and the WTO in key ECOSOC and UNGA meetings represent a start, they are still too static and ritualistic to have much impact. One practical approach to agenda-setting, for example, would be for the UN (i.e., different UN institutions, including UNCTAD) to get more actively involved with key expert institutions on economic policy, and to gradually develop a niche, whereby the UN is seen as an attractive source of mandates for world-class economic policy research and

analysis. This should as a rule be done with a view to complementarity rather than direct competition with the Bretton Woods Institutions and the WTO, without this concern being a strait-jacket for the UN in a dynamic process of globalisation.

An important condition for UN success in these respects is to ensure top-level quality in staff and work on global economic governance. Given the UN's rather marginal position right now, we are faced with a *Catch-22* type problem: the UN needs a stronger profile on global economic governance in order to attract the best people, while it depends on the very same people to move the institution towards such prominence. This dilemma should not be allowed to paralyse UN efforts in this area, however. One place to start is to reflect on whether the salary and benefit system is flexible enough to recruit world-class competence in areas of urgent priority. That also requires, however, a clear sense of priority as to what exactly the UN niche in global economic governance should be, drawing on the comparative edge logic presented above.

Reforming the Governance of the Bretton Woods Institutions

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Abstract

During the 1990s, the BW Institutions paid increasing attention to governance issues in their member countries. It is interesting to examine the governance of the BWI. To what extent does it meet the standards of transparency and accountability these institutions regard as necessary for the good use of public resources. The paper reviews in detail the power structure of the IMF, i.e., the role of basic votes, the distribution of quotas and the role of the Executive Board, management and staff in decision-making, closely paralleled by that of the World Bank. It finds that the concentration of power in a few member countries impairs the transparency and political accountability of both institutions.

It reviews the recommendations of the Report on the Adequacy of the IMF Quota Formulas, including its proposals for change, and finds that it fails to address such key issues as the Fund's size, the overall adequacy of quotas, the question of basic votes and the distribution of voting power. It questions the rejection of PPP-based GDP in the proposed formula for quota determination, a decision that would introduce a bias against developing countries, and finds the exclusion of short-term capital volatility in the measurement of countries' external vulnerability also questionable.

The paper concludes that important aspects of the governance system have become dysfunctional because the quota structure does not adequately reflect the changes that have occurred in the world economy since the Bretton Woods Conference in 1944.

1. Introduction

At the end of World War II, the Bretton Woods Conference gave birth to the International Monetary Fund and the International Bank for Reconstruction and Development, better known as the World Bank (WB), the two international financial institutions that have come to exert a major, and some would say, dominating, influence on economic policy in the developing countries over the past half century.

It would not be an exaggeration to say that as the economic thinking of the IMF and the WB evolved, a parallel evolution took place in the policies of most of their developing country members. It is therefore of interest to investigate how these institutions are governed and to examine the major political influences on their thinking and policies.

For simplicity of exposition, the paper will focus on the IMF and make only occasional references to the WB. This is justified not only by great parallelism in the composition of shareholding and the resulting political structures, but also by similarities in the governance of the two institutions and in the way they respond to the same influences and power structure.

Since 1997, following the approval of the Guidance Note on Governance by the Executive Board, the IMF has given increased attention to governance issues in its member countries. The promotion of transparency and accountability is at the core of the Fund's efforts to ensure the good use of public resources as well as the domestic ownership of programs. In recent years, the Fund has developed and applied its instruments for promoting these objectives to an extent well beyond what was envisaged at the time the Guidance Note was approved.¹ Indeed, the Fund now helps countries identify any weaknesses that may exist in their institutional and regulatory frameworks that could give rise to poor governance, and provides support in the design and implementation of remedial reforms. Given the strength of the vested interests that benefit from lack of transparency and accountability, overcoming these weaknesses often requires undertaking significant structural reforms.

1. See "Review of the Fund's Experience in Governance Issues," SM/01/30, March 29, 2001 IMF, Washington, DC.

Although the IMF is reluctant to attract media attention, its considerable influence over the majority of its 183 member countries is well known. It exerts a significant, often decisive influence on such economic and politically sensitive matters as wage policies, taxation and public expenditure levels, public sector prices and tariffs, subsidies and pensions, privatization policies, the exchange regime and the exchange rate, interest rates and monetary policy, trade policy and financial sector regulations.

Although the IMF is quite different from the World Bank in its size, structure and operations, the functions of the two agencies have converged in recent years. The division of labor set forth at Bretton Woods, under which the IMF had primary responsibility for short-term exchange rate management and correcting imbalances in external accounts, while the Bank made long-term investments in development projects, persisted through the 1960s. When the Bretton Woods system of fixed exchange rates collapsed in the early 1970s, the Fund became increasingly involved in stabilization and the time frame of its activities lengthened. In 1980, the World Bank began making structural adjustment (that is, non-project) loans that are disbursed over a shorter period and are conditional on economic policy reform in member countries. These changes brought about a state in which the Bank and the Fund were 'both providing balance of payments loans, tranching over one to three years, with medium term amortization periods. Both programs supported macroeconomic and microeconomic adjustment, focused on improving both external and internal accounts.' (Feinberg, 1988, pp. 549-50.).

The blurring of responsibilities became even more evident during the debt crisis of the 1980s when both institutions played a major part in channeling capital to heavily indebted countries. (Miller-Adams, pp. 15-16.)

With resources of over US\$280 billion and an expanded mandate, the Fund is probably the most powerful of all international institutions. In view of its influence, it is interesting to consider to what extent the Fund's own governance meets the standards of transparency and accountability required to ensure the legitimacy of its decisions, the ownership of programs by member countries and the good use of public resources.

To do so, we must begin by understanding its power structure and the rules by which it is governed. This requires reviewing the role of basic votes and quotas in the determination of voting power, the current distribution of

voting power, and the requirements of special majorities and how they affect political control and accountability. In view of the overwhelming importance of quotas in decision-making, we shall review the formulas for the determination of quotas and consider the proposal for their revision that was put forward by the Quota Formula Review Group appointed by the Managing Director in 1999. Finally, we shall suggest what main elements a reform of the governance of the Fund should comprise. Those needed for a reform of the Bank's governance would be very similar.

We shall see that there can be little doubt that a far-reaching reform is required to enable the Fund and the Bank to play the role their founding fathers envisaged for them in a much changed world economic and political environment. Whether reform takes place, and how far it goes, will depend on the vision of the men at the helm of the major industrial countries, particularly the US.

2. Votes and Decision-making

Although the IMF is an international organization, its members do not have equal voting power. The acceptance of weighted voting is a departure from the traditional practice of international organizations. The vote of an IMF member has two components. Each member has 250 basic votes simply by virtue of its membership; this is a symbolic recognition of the principle of the legal equality of states. Each member also has one additional vote for every SDR 100,000 of its quota. Because the number of basic votes has not been changed with successive quota increases, the ratio of basic votes to total votes has declined from 12.4% of the voting power of the countries participating in the Bretton Woods Conference (Articles of Agreement, Schedule A) to 2.1% today, despite the entry of 135 new member countries. In fact, as a proportion of the total, the basic votes of the original members declined from over 12% to under four one-thousandths of a percent, i.e., from 0.124% to 0.0038%, as a result of a 37-fold increase in total quotas.

At the Bretton Woods Conference in 1944, a compromise solution was adopted between two approaches for determining voting power, one related solely to members' contributions, or quotas, and another based solely on the legal principle of the equality of states. The compromise assigned voting rights on a combination of the two: it gave each member country one vote

for every US\$100,000 of quota (later for every SDR 100,000) plus 250 basic votes. Basic votes, and the voice in decision-making they gave smaller countries, were also considered to be necessary in view of the regulatory functions of the Fund in certain areas. (See J. Gold.)

Similarly, Article V, Section 3(a) of the Bank's Articles of Agreement provides that "each member shall have 250 votes plus one additional vote for each share of stock held." All shares of the Bank's capital are valued at US\$120,635 per share. In 1979, all members of the Bank were offered the possibility to subscribe 250 "membership" shares to avoid a dilution of the voting power of the smaller members as a result of the 1979 capital increase. New members are also authorized to subscribe 250 shares.²

With the increase in quotas (shares), the proportion represented by basic votes in the total falls, which raises the relative voting power of larger countries. With the accession of new members, the total number of basic votes rises, but not necessarily their share; nevertheless, the importance of the basic votes of any given member in the total continues to diminish. The expansion in membership from 45 to 68 caused the share of basic votes to rise from 11.3% in 1945 (the difference between that figure and the original 12.4% in Schedule A reflects the withdrawal of the Soviet Union and other countries) to 15.6% in 1956 simply because no significant increase in quotas had taken place. But with the nearly 37-fold increase in quotas since then, the share of basic votes in the total has declined (to 2.1%) despite a four-fold growth in membership. This has substantially shifted the balance of power in favor of large countries, away from the compromise agreement contained in the Articles that was designed to protect the participation of small countries.

Since the importance of the basic votes of a country is inversely related to the size of its economy, the power structure of the Fund has changed over time. Allow me to illustrate the shift that occurs as quotas increase: A country with a quota of ten million would be entitled to 350 votes, i.e., 100 votes on account of its quota size and 250 basic votes for being a member. When the

2. Under the Bank's current practice, the capital subscription of a new member consists of two components. The first is an obligatory subscription, which the new member must make at the time it joins the Bank. This obligatory subscription has two parts. The first is derived from the member's quota in the Fund and is currently equal to 88.29% of the member's Fund quota. The second part is based on a fixed number of 195 shares, which represent the portion of the membership shares corresponding to the increase in the subscriptions of members which was authorized in conjunction with the Bank's 1988 general capital increase. The second component, subscription of which is optional, consists of 250 shares with respect to which no payment is due at the time of subscription. All shares of the Bank's capital are valued at US\$120,635 per share.

size of quotas is multiplied by ten, the country will have 1,000 votes on account of its quota and 250 basic votes, for a total of 1,250 votes. Thus, the relative share of basic votes declines from over 70% to 20% of the total.

In 1945, there were fourteen countries, or almost a third of the membership, whose quota was US\$10 million or less, and twenty-eight countries, over half of the total, whose quotas were US\$50 million or less. With the passage of time, inflation and growth have combined to increase the size of the quotas, but as the number of basic votes has remained constant, their relative participation in the total has declined.

As a result, quotas (or shares, in the case of the Bank) are today virtually the sole determinant of voting power, and basic votes are of very little significance. Consequently, the voice of small countries in discussions has been substantially weakened, and their participation in decision-making has been reduced to the point of becoming negligible. A similar process of erosion in the role of basic votes has taken place in the Bank over time as a result of successive capital increases. The developing countries have repeatedly and fruitlessly raised the question of the need to increase the number of basic votes in order to maintain a better balance in decision-making.

Since the issue of basic votes would appear to be a major issue in the governance of the Fund, it is surprising that despite the broad mandate given to the Quota Formula Review Group,³ appointed by the Managing Director in 1999, their Report fails to consider the possibility of revising basic votes. There is only one reference to basic votes in the Report:

The IMF's cooperative nature suggests that potential debtor countries should continue to have a significant voice in IMF decision-making, a feature that would be dropped by basing quotas solely on the ability to contribute (unless redressed by increasing substantially the fixed or basic votes to which each country is entitled, which now accounts for about 2% of total votes – a change that would require amendment of the Articles). With quotas and hence voting power, based solely on the ability to contribute, some feel that the perspective of prospective borrowing countries would not be properly reflected in the management of the IMF.

3. Articles of Agreement, International Monetary Fund, Washington, DC., April 1993.

Thus, while recognizing that the cooperative nature of the international institution calls for having prospective borrowers represented in decision-making in the Fund, the authors of the Report appear to believe that with basic votes accounting for 2.1% of the total vote, a figure that includes the votes of developed countries, potential debtors have *a significant voice in decision-making!* It is difficult to take this argument seriously. One may ask, what parliamentary body would consider such a small representation of a major party to be adequate participation in decision-making? The authors of the Report would appear to have forgotten how basic votes evolved. Since they are aware of the reasons for the compromise that led to having voting rights based on a combination of two criteria, perhaps they know that the major industrial countries would prefer that the issue not be raised.

However, the preservation of the share of basic votes in the total would not be an exceptional practice among international institutions. Being sensitive to the political dimension of its work, MIGA would allocate developing countries as a group the same voting power as developed countries, if all members of the World Bank joined the Agency. The Articles of Agreement of the Asian Development Bank provide that the relative importance of basic votes will remain constant over time as a proportion of the total vote (Article 33-1). The Articles of Agreement of the Inter-American Development Bank provide that no increase in the subscription of any member will become effective, if it would reduce the voting power of certain countries or groups of countries below certain given percentages of the total. (See External Review of Quota Formulas – Annex, Box 3.1, page 38.)

Restoring the share of basic votes to, for example, the original 11.3% of the total (op. cit., page 32) would require a more than five-fold increase in the basic vote of every member country (from 250 to 1,323). Restoring the proportion of basic votes per member to what it was in 1945 would raise the total basic votes to nearly half of total voting power (11.3% x 4,079 more members = 46% of total vote). An intermediate solution that would partially restore the role basic votes were meant to have, would be to assign to basic votes say, 25% of the total voting rights. This would mean raising the basic votes of each member country from 250 to 2,927. In order to prevent the future erosion of the share of basic votes in the total, the Articles could be amended to include a provision by which in every quota review, total basic votes would increase by the same proportion as total quotas.

3. Qualified Majorities

Most IMF decisions are taken without a formal vote, simply by interpreting the opinion of the Board. The Fund's Secretary arrives at this opinion by taking an informal tally of the executive directors – who are for or against a decision – and their voting power. In practice, this often means an additional loss of influence for the numerous developing countries that are represented at the Board by a developed country director, since the director's position will normally reflect that of the majority of the votes in his constituency; after all, the Articles state that “all the votes which an Executive Director is entitled to cast shall be cast as a unit.” (See IMF Articles of Agreement Art. XII, Section 3, iv.)

The Articles of Agreement stipulate that some decisions require a qualified majority of the votes cast, that is, a particular proportion of the votes. At the Bretton Woods Conference, it was proposed that qualified majorities should be required in only two cases (one being quota adjustments), yet the subsequently accepted Articles of Agreement required qualified majorities for decisions in nine areas. With the First Amendment to the Articles of Agreement, the number of these decisions rose to eighteen; with the Second Amendment, the number rose to fifty-three. Forty of these are Executive Board decisions; thirteen are Board of Governors' decisions.

The obvious explanation for the increase is the desire to protect a particular interest that might be affected by such decisions, as decisions subject to a qualified majority can be taken only with the consent of the members having a high proportion of the total votes. Currently, the United States has 17.35% of the total vote, Japan has 6.22%, Germany 6.08% and France and the United Kingdom have 5.02% each. The G-7 countries have a combined total vote of 47.7%, and together with the Swiss Director they account for 50.34%. If the votes cast by the Dutch and Belgian directors are also added, the G-7 countries' combined vote exceeds 60%.

The concentration of voting power in the hands of the major industrial countries ensures that they have a controlling influence on IMF policies. Nevertheless, some of them have, in addition, sought actual veto power either for themselves or for a few countries with similar interests. The result is that decisions on eighteen subjects require 85% of the total vote, and can thus be vetoed by one member country alone. Twenty-one other questions

must be decided by a 70% majority, and can thus be vetoed by the five countries with the most voting power. (While the role of qualified majorities in the Bank is less pervasive, certain decisions, i.e., the amendment of the Articles of Agreement, that originally required three-fifths of the members having four-fifths of the total voting power, was amended to 85% in 1989 in order to preserve the US veto.)

Among the issues that the IMF Executive Board may resolve only by qualified majority are decisions on quota size, rates of charge, exchange-rate arrangements, matters related to SDRs, policies on access to IMF resources, payments to the IMF, use of the Fund's gold holdings and reserves, management of the IMF's investment accounts, publication of reports, remuneration of creditor positions, and temporary suspension of IMF operations. Thus, all decisions related to the size of the IMF and the use of its resources, to SDRs, gold, and the international monetary system are subject to the will of one or a few countries.

Special majorities have been used to block decisions supported by an absolute majority of votes on increases in the size of the IMF (that is, quota increases) and on SDR allocations, sales of the IMF's vast gold holdings, and policies on access to IMF resources. The special-majority requirement has often had the effect of inhibiting even the discussion of important issues that would be difficult to resolve.

The developing countries have argued that because voting itself is weighted – a situation that favors the industrial countries in decision-making – there should be no need for special majorities. For various reasons, however, the countries that have favored such majorities have not been prepared to do away with them.

4. Political Control and Accountability

In principle, the staff and management of the Fund (Bank) are subject to the political control of and accountable to the Board of Governors and its representatives, the executive directors. Thus, the line of control and supervision runs from the Board of Governors, formed by the finance ministers and central bank governors of member countries, to the executive directors who represent them, to the manager of the Bank and Fund, whom they appoint, and to the staff that management supervises.

Formally, the Executive Board, in which all member countries are represented, appoints the Managing Director of the Fund and the President of the World Bank. However, in practice there is an unwritten understanding among major industrial countries by which the US appoints the President of the World Bank while the Managing Director of the Fund is appointed by the European members. As a result, a handful of European officials, essentially British, French and German, feel it is their prerogative to appoint the Managing Director of the IMF with the consent of the US and with little reference to the rest of the membership.

The widely publicized discussions and disagreements between the US and the German governments that preceded the appointment of the Managing Director of the Fund in 2000 had a touch of black comedy, since the US rejected the first German candidate. This farce should have dispelled any illusions as to the participation of most countries in the process. As the *New York Times* pointed out in its editorial comment,

[t]he Managing Director is too important to be chosen in secret by a few self-selected European countries. The IMF comes to the rescue of countries in distress, offering billions of dollars in loans if they adopt stringent economic reforms. It currently oversees about 50 such programs in Latin America, Africa, the former Soviet Union and Asia. Critics say the programs can cause needless economic pain. (*NYT* 23/11/99)

Further, the Managing Director's judgement will often determine "whether the Korean currency should be defended, in the face of a looming depression by doubling interest rates. It [the IMF] decides whether to crack down on insolvent Indonesian banks, throwing the economy into a tailspin, or to prop up possibly corrupt or bankrupt institutions."

The selection process has to be opened up. Candidates for the position should state what their policies would be and how they would guide the Fund to attain its purposes. Since the Fund's operations are entirely with developing countries and transition economies, it is neo-colonial to assume that only a European is capable of becoming Managing Director – or that only an American can be President of the Bank. It is also entirely implausible to assume there is no highly qualified national of a developing country that could fill the position. The issue is doubly important as the Managing Director of the Fund and the Bank's President and their senior staff can, in practice, only be held accountable by the governments of a handful of countries.

Executive directors have a double role; they are not only national representatives but also Fund or Bank officials whose salaries are paid by these institutions. On one hand, they collectively determine the policies under which the organization is run and appoint the Managing Director, who, in turn, appoints and supervises the staff. On the other hand, they represent member countries. However, the directors who represent developing countries (most of which will turn to the Fund for financial support from time to time) have a very limited ability to hold the staff, much less, the Management, accountable. The first reason for this is their limited voting power, which means they have little say on their promotion or removal. The second reason, no less important, is that being the representatives of petitioner governments limits the ability of these directors to question the staff, particularly that of their area departments, since they have to rely on that same staff to prepare the papers that present their case for financial support to the Board. In addition, some directors may be overwhelmed by the power of the institution and may lack the combination of self-confidence and technical expertise to challenge the assumptions or methodology of the generally very competent staff. This is of particular importance for developing country directors, since the balance of power is loaded against them. Questioning the staff and management may be particularly difficult for directors who come from cultural traditions where respect for authority is greatest.

“As its own bilateral program has shrunk, the US has found the World Bank an especially useful instrument for projecting its influence in developing countries. The bank is a source of funds to be offered to US friends or denied to US enemies,” argues Robert Wade of the Institute for Advanced Study in Berlin.

Although no other member states come close to matching US power over the bank, all its influential owners – Britain, France, Germany and others – have borrowing governments they purport to sponsor, as well as key issues (such as the environment) that are viewed as important by their electorates. Otherwise, accountability and scrutiny from donor governments are uneven at best and non-existent at worst. Meanwhile, the few powerful borrowing nations that could exert some influence are afraid to voice their concerns lest they lose access to bank finance. (See S. Fiedler, “A World of Complaint” in the *Financial Times*, Aug. 28, 2001.)

Not wishing to diminish their own effectiveness in securing financial support for the countries they represent, directors may not wish to challenge or antagonize senior staff, much less the management, on whose judgement and goodwill their countries must rely. This constraint tends to create a dependence that affects different groups of countries from the poorest, which may be seeking to qualify for the HIPC Initiative, to the larger, more advanced emerging market economies of Asia or Latin America, which may require the support of the Fund and favorable staff judgements to preserve or restore the confidence of private capital markets in their economies. (See A. Mohammed, page 10.)

From the standpoint of transparency and accountability, a particularly sensitive issue arises when the staff and management impose prerequisites, such as the adoption of certain measures or the fulfillment of certain “pre-conditions,” on a country requesting a program – without the knowledge of the Board.

In practice, the ability of developing country directors to exercise effective control over staff and management is seriously impaired. Indeed, directors who try to exercise their supervisory role run the risk that the staff or management will complain about them to their authorities at the time financial support from the Fund is negotiated, giving rise to a particularly delicate situation for directors from third countries, since the confidence of the authorities in them may be undermined. Note that only Brazil, India, Iran, and South Africa are permanently represented by their own nationals, while Algeria, Argentina, Mexico, Pakistan and Venezuela occupy the Executive Director Chair in either the IMF or the World Bank by rotation (op. cit., page 4).

Given their limited voting power, developing countries are forced to join other countries to muster a sufficient number of votes to elect an executive director to represent them at the Board. As a result, developing country constituencies or “chairs” representing several countries, usually rotate the positions of Executive Director and Alternate Executive Director every two years among the several member countries they represent. While this policy, followed by most developing country constituencies, gives a large number of countries access to the Board, it has two serious disadvantages. The first disadvantage is the directors appointed through this rotation system are not familiar with the complexities and the policies of the institution, its programming techniques, or the policy precedents on which they can draw. It often takes a year before the newcomers become familiar with the *modus*

operandi of the institution. Consequently, they are at a considerable disadvantage in policy discussions *vis-à-vis* the staff and developed country directors of longer tenure and experience. Secondly, the staff members, whose appointments are permanent, know that these directors will depart at the end of the two-year cycle; if the directors request changes the staff does not favor, whether in the presentation of annual consultation reports or on policy matters, it can simply wait them out for a while, until the director in question departs from the scene.

A further result of the quota distribution is that country representation at the Board is necessarily skewed. Thus, 24 industrial countries, none of which has a Fund-supported program, are represented at any one time by ten or eleven executive directors, who generally receive very considerable technical support from specialized offices in their treasuries and central banks, and are able to devote much of their time to policy issues. At the same time, 42 African countries, excluding Arab states, are represented by only two executive directors. Consequently, each of those directors represents 20 countries or more and is barely able to attend to the copious amount of bilateral business the countries they represent have with the Fund. Several of these countries may be engaged in programs or program negotiation at any one time, and with no technical support from those capitals, these directors will have little time to devote to the consideration of policy and systemic issues. Consequently, their ability to participate in the informal consultations among directors that often determine the outcome of discussions on policy matters will be limited.

In the Bank, the problem may be even worse, given the large number and variety of projects and the fact that sub-Saharan African countries are also represented by only two directors. The situation of most other developing country directors, though generally not as extreme, is far from satisfactory. Of course, since developed country directors have a majority of the vote in both institutions, they need not go out of their way to consult directors outside their own group.

Developing country representatives at the Board, and their authorities, are “aware that any pronouncements they make on certain sensitive issues may affect the markets’ perception of their country’s policies and their standing in private financial markets.” (See Mohammed, page 5.)

While the Fund staff includes nationals from most (127 out of 183) member countries there is a longstanding predominance of nationals from

industrial countries among the management and senior officers. As listed in IFS, these accounted for 26 out of 31 officials listed as such five years ago (1996). The number had declined to 22 out of 29 listed officials in March 2001, but this still represented some three-quarters of the total. Moreover, numerous developing country nationals in senior positions went directly from a US university to a position in the Fund, and their professional experience was gained while rising through the ranks. Therefore, they cannot be said to bring the experience and sensibility that comes from work in their own countries. A training in economics in the better graduate schools in the US, UK or Canadian universities, which is common to a high proportion of the staff, provides remarkable homogeneity in economic thought, greatly facilitating communication and cohesion of staff members around what has been characterized as the “Washington consensus.” This common approach facilitates Fund operations, but at times may lead to a certain lack of pragmatism that creates difficulties in different environments. As the Bank’s official history states,

[t]he Americans had a secure enough lead in the Bank throughout the half century to help it avoid the clutter of country quotas in its hiring, to recruit personnel on merit from the developed and developing countries alike, and to build a work force that some saw as comparatively de-nationalized and homogeneous (although others, to be sure, perceived as a set of nationality cliques). One unmistakable factor that contributed to this homogenizing and that grew stronger over time was economics. As this work demonstrates, economics would become the Bank’s hallmark scholarly discipline, and the economists who heavily shaped Bank operations as well as its research were recruited from an array of countries. To a large degree, however, they were the product of the graduate economics departments of English-speaking, but especially American, universities. This fact, as it played into the Bank’s consulting, research, technical assistance and agenda setting, would enhance the US role in the institution beyond the apparatus of formal governance.

The full-time leader of a multilateral agency – president, managing director, director-general, or whatever – tends to be powerful *vis-à-vis* the representative component of agency government. Members of the agency board, even if full time residents, as in the case of the World Bank, are unlikely to be deeply schooled or experienced in the substance of the

program. But the pro-management tilt of power within the Bank was accentuated when, in 1947, the second president, John McCloy, imposed an agreement on the Executive Board that blocked it from taking operational initiatives. Henceforth, all loan proposals would have to come from the staff, that is, management. (See Kapur et. al., page 4.)

The similarities in training in a narrow range of institutions contribute to the preservation of an organizational culture. One study suggests that this creates a pressure for conformity and belief in a single truth in a manner similar to a religious institution:

Like any institution, the Bank has its own self reinforcing culture and its codes which set limits on what can reasonably be believed and discussed if one hopes to be taken seriously and remain a member of the group... Put in the same place several hundred people who have been trained in the same schools to think in the same way, recruit them precisely because they have excelled in this training... [and the] probable cultural outcome will be – at least among the economists – monolithic and fundamentalist.” (George and Sabelli 1994:102, quoted by Miller-Adams, op.cit., page 29.)

Moreover, in the light of the power structure of the Fund and Bank, and keeping in mind that economic policy is not an exact science, it is inconceivable for the staff not to be influenced by their knowledge of what country or groups of countries exert control over the institution and its policies, and what the interests of those countries are.

Furthermore, the current power structure, which places a small number of countries in a dominant position, impairs the objectivity of decisions and recommendations. While the dramatic experience of the volatility of capital flows and the high costs of the Mexican crisis of 1994-95 should have been sufficient to lead the Fund to take a careful second look at the risks implied by full capital account liberalization and the integration of developing countries with international capital markets, particularly of countries without strong banking systems, the Fund continued to vigorously pursue an amendment to the Articles of Agreement to demand the opening of the capital accounts of developing countries. Only well after the Asian crisis of 1997-98 did the Fund and the Bank concede that the volatility of capital associated with these crises raises questions about the desirability of completely free capital movements and full capital account convertibility. The staff report published in January 2000 “Country Experiences with the Use and Liberalization of

Capital Controls” finally concedes that controls have helped some countries insulate themselves – if temporarily – from financial crises and acknowledges that rapid liberalization can increase vulnerability to external and domestic shocks. This policy shift followed what were widely accepted as serious mistakes in the Fund’s performance during the Asian crisis.

Arguing for greater accountability and transparency, and for public scrutiny of Fund deliberations, an editorial in the *New York Times* stated,

[t]he IMF predicted that its intervention in Asia in 1998 would lead to a quick turnaround. Instead, it led to economic collapse, although Asia appears to be on the mend. Many of the countries in sub-Saharan Africa remain buried in debt and poverty despite two decades of IMF supervised economic reform. In Russia and Brazil, the IMF wasted billions of dollars and delayed reforms, by propping up currencies. In both cases the currencies collapsed anyway. (*NYT*, 23/11/1999.)

Technically questionable programs have sometimes been approved in order to support governments allied with the interests of the dominant country or countries, thereby placing the resources of the international community at risk. These cases have a demoralizing effect on IMF staff members, who are made to recognize that there are “special cases” based on non-economic considerations and who may, as a result, impose a degree of self-censorship.⁴ Thus, it is difficult, if not impossible, to examine and analyze objectively any initiatives or proposals that go against the interests of the major industrial countries.

5. The Determination of Quotas

Since members’ quotas determine to large extent their voting rights, contributions and access to resources, the process for setting such quotas should be examined closely. It has been said that the quotas of the United States, the United Kingdom, the Soviet Union, and China were politically determined at the Bretton Woods Conference. Raymond Mikesell, asked by the U.S. Treasury to estimate the first quotas, described how this was done:

4. The Quota Formula Review Group (QFRG) was formed by eight experts, Richard Cooper (Professor at Harvard University) as chairman; Joseph Abbey (Executive Director, Center for Economic Analysis, Accra, Ghana); Montek Ahluwalia (Member, Planning Commission, New Delhi, India); Muhammad Al-Jasser (Vice-Governor, Saudi Arabian Monetary Agency); Horst Siebert (President, Kiel Institute of World Economics, Germany); Gyorgy Suranyi (President, National Bank of Hungary); Makoto Utsumi (Professor, Keio University, Japan); and Roberto Zahler (former President of the Central Bank of Chile).

In mid-April 1943, ... White called me to his office and asked that I prepare a formula for the ... quotas that would be based on the members' gold and dollar holdings, national incomes, and foreign trade. He gave no instructions on the weights to be used, but I was to give the United States a quota of approximately US\$2.9 billion; the United Kingdom (including its colonies), about half the U.S. quota; the Soviet Union, an amount just under that of the United Kingdom; and China, somewhat less. He also wanted the total of the quotas to be about US\$10 billion. White's major concern was that our military allies (President Roosevelt's Big Four) should have the largest quotas, with a ranking on which the president and the secretary of state had agreed. ... As was typical, White wanted something on his desk in a couple of days – it took me four, including a weekend. A modern computer would have saved several days of work on my state-of-the-art calculator and might have produced a more credible result.

Had there been reasonably good official national income estimates for the major countries in 1943, it might not have been possible for me to approximate White's conditions. Only the United States and Britain had official figures, although several countries had unofficial estimates. There were published figures on gold and dollar holdings (except for the Soviet Union) and on foreign trade, but no formula could meet White's conditions without giving great weight to national income. My sources for the national incomes of the thirty-four countries I covered were estimates of average consumption found in country studies, estimates of wage rates and family expenditures and extrapolations from budget and tax data. Countries at a similar stage of development were assumed to have the same *per capita* income. My national-income estimate for China was US\$12 billion, less than a fifth of U.S. national income in 1940, and my estimate for the Soviet Union was US\$32 billion. I confess to having exercised a certain amount of freedom in making these estimates in order to achieve the predetermined quotas. I went through dozens of trials, using different weights and combinations of trade data before reaching a formula that satisfied most of White's objectives. I then found that I could get even closer if I increased the quotas by the ratio of average exports to national income. . . . Not all the estimates were for a common date, but I tried to adjust the data to 1940. The final formula for determining quotas was 2% of national income, 5% of gold and dollar holdings, 10% of average

imports, 10% of the maximum variation in exports, and these three percentages increased by the percentage ratio of average exports to national income. (Mikesell, 1994, pp. 22-23.)

Subsequently, at the meeting of the Committee on Quotas, Mikesell was asked to explain the basis for his quota estimates:

I had anticipated this request and gave a rambling twenty-minute seminar on the factors taken into account in calculating the quotas, but I did not reveal the formula. I tried to make the process appear as scientific as possible, but the delegates were intelligent enough to know that the process was more political than scientific... The use of a single Fund quota to serve three purposes was both illogical and unnecessary, and this was frequently pointed out during the conference. There could well have been one quota based on, say, foreign trade and export variability to govern drawing rights, a second quota based on reserves and balance-of-payments history to govern contributions to the Fund, and a third quota based on economic and political importance to determine voting rights. (R. Mikesell, 1994, pp. 35-38.)

It is remarkable that, with some adjustments in the weighting and definition of the main variables, the IMF continues to use the original formula for determining members' quotas, and it is certainly understandable that the lack of equity and rationality in the quota criteria continue to cause controversy and mistrust among members today, just as it did fifty years ago. The original formula is now combined with four other formulas, which give different weights to the same variables, and an element of discretion is used in selecting the formula to be applied in each case. (At times, the average of the various calculations is used to set a country's quota.) It is therefore not surprising that current quotas are far from representative of the actual sizes of economies, of their ability to contribute to the Fund or of their importance in the world economy.

This can be easily illustrated by the fact that such large countries as China, Brazil, Mexico and Korea with real GNPs and populations much larger than those of Belgium, the Netherlands and Switzerland, have quotas that are only a fraction of the latter countries' – and fewer votes. Thus, their share in decision-making is not commensurate with the systemic importance of their economies. (See Table 1.)

Table 1:
**Quotas and GNP of Selected Countries Following
the Eleventh Quota Review in 1998** (in billions)

Country	Quotas (SDRs)	GNP (PPP)	GNP (US\$, 1998)
Russia	5.945	580.3	337.9
Netherlands	5.162	339.3	388.7
China	4.687	3,983.6	928.9
Belgium	4.607	239.7	259.0
Switzerland	3.458	189.1	284.8
Brazil	3.036	1,021.4	758.0
Mexico	2.586	785.8	380.9
Denmark	1.643	126.4	176.4
Korea	1.634	569.3	369.9

Source: IMF for quotas; World Development Report 2000 of the World Bank for GNP figures

It would be difficult to argue that, for instance, the quota of China, the second largest economy in the world measured in terms of purchasing power parity, should be smaller than that of the Netherlands and similar to that of Belgium! Or that Belgium's quota, and therefore influence on governance, should be 52% larger than that of Brazil and 74% larger than that of Mexico. Or that Denmark should have the same weight in international monetary and financial decision-making as Korea. Moreover, it appears that many of the major differences arise mainly between the quotas of developed and developing countries and are not simply the result of history. In the calculation of quotas for Switzerland, a recent member of the Fund, the quota was determined in line with that of other industrial countries with a similar economic structure and levels of development. As a result, the distribution of quotas is skewed.

Table 2:
Quota Distribution by Country

	Item (in millions of SDRs)	Quota (in %)
Total Quotas	212,401	100.0
24 Industrial countries	130,567	61.4
Oil exporting countries	20,307	9.6
Non-oil developing countries	61,527	29.0

Source: IFS, March 2001

Quotas largely determine a country's access to financing. Except in exceptional cases, a member can borrow up to a total of 300% of its quota under regular facilities. Thus, the small quotas of developing countries limit both their share of voting power and their access to Fund resources.

The consequences of the imbalance of power have been further aggravated by the fact that since the late 1970s no industrial country has resorted to Fund support. This development has changed the nature of the Fund. Formerly, when the Fund was a credit cooperative and all members drew resources from it time to time, they all had an interest in these resources being available on reasonable terms and conditions. Over the years, however, the Fund has turned into an institution consisting of two distinct groups of countries: industrial country creditors and developing country debtors. The fact that for over twenty years the Fund has lent only to developing countries has come to mean that the creditor countries try to lend as little as possible and therefore favor a hardening of conditionality, while prospective borrowers, generally wish to have ample access to financing on easy terms and tend to be defensive of their country's short-term interests. Thus, the objectivity and impartiality of the Board, assumed by the Articles of Agreement, has been eroded to a significant extent.

According to the Articles, quotas are to be reviewed by the Board of Governors at intervals of no more than five years and, if appropriate, adjusted. (Articles of Agreement, Art. III, Sec. 2a.) The distribution of quotas tends

to maintain the existing structure, one similar to that of half a century ago, largely because of the element of inertia that resulted predominantly from so-called equiproportional quota increases, by which the quotas of all countries are increased by a similar proportion. On average, some 70% of all increases have been across the board, all quotas rose by the same percentage of increase. While this procedure avoids, at times, the acrimonious discussions of countries' relative positions, it produces a substantial inertia in quota shares. As a result, quotas do not adequately reflect the changes that have taken place in the world economy since 1944. In the recently concluded Eleventh General Review of Quotas, 75% of the quota increase was distributed in proportion to members' shares in the total of pre-existing quotas, calculated according to the formulas. The other 25% was distributed in a somewhat discretionary manner, 15% based on the formulas that measure relative positions and 10% to correct the position of those countries whose calculated quotas most exceeded their shares in actual quotas. This was done in order to bring the quotas of those countries whose calculated quotas most exceeded their actual quotas, more in line with their relative economic positions.

However, in the past, the changes in the quotas of the main industrial countries were not simply based on the formulas, questionable as they may be, but on political criteria. Thus, in the Ninth General Review, Japan's and Germany's quotas were equalized (both in second place), although the Japanese economy was twice the size of the German economy. Similarly, the third largest quotas were given to France and the United Kingdom, although the Italian economy was somewhat larger than that of the United Kingdom at the time. Very recently, China's quota was revised to take into account the incorporation of Hong Kong into China. Set at SDR 6,369.2, China's new quota is exactly the same to the decimal point, as that of Canada, the smallest member of the G-7.

Major industrial countries have implicitly recognized the limited representativeness of the Fund's Executive Board for several years through the formation of the G-20. This is an *ad hoc* forum of finance ministers and central bank governors established in the late 1990s on the initiative of the US as a means for the G-7 to sustain a dialogue on financial matters with certain "systemically significant" countries (Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey) whose representation in the Fund is limited. Unfortunately, as this forum is

outside the Fund, it excludes the majority of the Fund members from participating in its discussions, which thus raises questions as to its legitimacy. While the issues discussed by this group initially were largely limited to the domestic vulnerability of emerging market economies to financial crises in view of the volatility of capital movements, more recently the agenda has been broadened to include the costs and benefits of globalization. The agenda of the group has yet to include any of the core systemic issues related to the governance, transparency and accountability of the current monetary arrangements.

6. The Report of the Quota Formula Review Group

Reflecting broad dissatisfaction with the existing quotas, the Report of the Executive Board to the Board of Governors on the increase in quotas under the Eleventh General Quota Review reaffirmed the view of the Interim Committee that the quota formulas should be reviewed following the completion of that review. Accordingly, in 1999, the Managing Director requested a group of external experts, under the chairmanship of Prof. Richard Cooper of Harvard University, to provide the Board with an independent report on the adequacy of the quota formulas, including proposals for changes, if appropriate. The terms of reference for the study given to the group were broad and included the following main areas:

- To review the quota formulas and their working, and to assess their adequacy to help determine member's calculated quotas in the IMF in a manner that reasonably *reflects a member's relative position in the world economy* as well as its *relative need for and contributions to the Fund's financial resources*, taking into account *changes in the functioning of the world economy* and the international financial system in the light of *the increasing globalization of markets*.
- To propose, as appropriate, changes in the variables and their specification to be used in the formulas.
- *To examine other issues directly related to the quota formulas.* [Italics mine.]

The "Report to the IMF Executive Board of the QFRG" (Cooper Report) was submitted to the Managing Director and to the Executive Board of the Fund on April 28, 2000. Because of its importance and because it will be considered by the Board in its next quota review, which is to be completed by early 2003, it seems appropriate to offer some comments on its scope and recommendations.

(A) The Size of the Fund

First, it should be noted that the work of the QFRG is necessarily developed in the framework of the Articles of Agreement, which set out the purposes of the Fund. Moreover, two of the three roles performed by quotas in the Fund are the provision of contributions to and access to Fund resources. Secondly, it should be observed that the terms of reference state that the mandate of the group is a broad one that explicitly includes changes in the functioning of the world economy and the international financial system in the light of the increasing globalization of financial markets.

The first question to address would appear to be the adequacy of the Fund's resources in relation to the tasks it has been assigned. Is the size of the Fund, the sum total of quotas, appropriate to enable it to fulfill its mission? After all, the purposes of the Fund include “[giving] confidence to members by making the general resources of the Fund temporarily available to them... *providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.*” (Article I, Section V of the Articles of Agreement.) [Italics mine.]

Furthermore, there has been a substantial decline in the size of the Fund in relation to world trade (see Table 3). As a result, Fund quotas accounted for barely 6% of world imports in 1998. Consequently, the resources of the Fund are not adequate to enable it to provide sufficient credit to its member countries suffering trade imbalances to allow them to adjust without resorting to a sharp reduction in aggregate demand leading to a downturn in economic activity.

Table 3:

Fund Quotas as a Proportion of Imports and GDP

	1944	1950	1965	1970	1978	1990	1998
Ratio of quotas							
to imports	0.58	0.17	0.15	0.14	0.09	0.06	0.06
Ratio of quotas							
to GDP	0.04	0.02	0.02	0.02	0.01	0.01	0.01

Source: Report to the IMF Executive Board of the QFRG, Table 7, page 37

Moreover, in recent years, the extraordinary growth of international financial markets and the increased dependence of a significant number of emerging market and transition economies on this source of financing has made them highly vulnerable to the volatility of short-term capital. The amounts of financing required to deal with such crises are much greater than those needed to address traditional payments imbalances. For instance, countries have traditionally required support to deal with their current account deficits. These are considered too large to be sustainable when they are on the order of 5% of GDP. Capital maturities falling due in the short-term, however, are estimated at over 30% of GDP in emerging markets.

As we have seen in the cases of the Mexican, the Asian and other financial crises, the resources provided by the Fund have proven to be entirely inadequate to enable countries that have come under a massive speculative attack to *avoid measures that are destructive of national and international prosperity*. Generally, the Fund's resources were supplemented by credits from other sources, with resulting increases in complexity, delays and, at times, unwarranted conditionality demanded by certain creditor countries participating in the financial rescue package. (See M. Feldstein.) Nevertheless, in all cases, the affected countries have suffered a massive devaluation, followed by a deep recession associated with income losses equivalent to several percentage points of GDP, a sharp rise in inflation and unemployment, and often a banking crisis resulting from a wave of bankruptcies, while their trading partners faced substantial losses in exports. (See Buira, 1999.)

Thirdly, the QFRG is mandated to examine *other issues* directly related to the quota formulas. One such issue could be the inclusion of one or more variables to relate quotas to the growth of the world economy, or of world trade, and the development of international financial markets.

Surprisingly, although it was given a broad mandate and asked to examine "their relative *need for and contributions to the Fund's financial resources*, taking into account *changes in the functioning of the world economy and the international financial system and in the light of globalization of markets*" the QFRG interpreted its mandate so narrowly as to preclude considering the adequacy of quotas and chose to focus only on the distribution of quota shares among member countries.

Did the QFRG consider the size of the Fund to be unimportant? Perhaps they knew that a review of this broader question would lead them to call for a sharp increase in the Fund's resources, a result the major industrial countries, which have sought to limit their budgetary contributions to international financial institutions, would not have welcomed.

In recent years, with the increase in capital mobility, developing countries have become much more vulnerable than in the past. They have frequently faced massive capital outflows that led to financial crises. The financial support required in such cases is much larger than that necessitated by traditional balance of payments crises and is greatly in excess, both in absolute terms and as a proportion of quotas, of that contemplated by the Fund's policies.

In a number of well-known cases, however, such exceptional support has been forthcoming. Mexico, for example, received US\$48 billion, of which SDR12.3 came from the Fund; Korea got US\$57 billion, of which SDR 15.5 was from the Fund; Indonesia, US\$43 billion; Thailand, US\$17 billion; etc. This support has been decided on an *ad hoc* discretionary basis, by major industrial countries outside the framework of Fund policies. Of course, such arrangements are unlikely to comply with the principle of equality of treatment for all members. As the Fund's resources have not kept pace with financing needs, countries do not know what, if any, financial support may be forthcoming. Does this lack of transparency as to what support may be available matter? Some developed country high officials defend this discretionary approach, which they have characterized as one of "constructive ambiguity," on the entirely implausible grounds for anyone familiar with the economic and social devastation caused by these crises, that a predictable framework for financial support would encourage moral hazard on the part of prospective Fund debtors. Placing the discretion of the strong over predictable rules does not rate high marks in terms of equality of treatment, transparency and accountability, and may be seen as a step backwards in international relations.

Could countries obtain financing from the markets? In fact, at times of great uncertainty or crisis it is very difficult for any country to obtain significant financing from the markets, and normally countries cannot. In such circumstances, in the absence of sufficient financial support from the Fund, bilateral assistance may come with conditions and strings attached that

have no bearing on the resolution of the crisis. For instance, support for Korea was made conditional on that country's implementing eight structural measures, which included allowing foreign investors to purchase Korean businesses; opening the domestic financial sector to foreign banks and insurance companies; and liberalizing imports of some industrial products, especially Japanese cars.

The fundamental issue is the appropriate role for an international agency and its technical staff in dealing with sovereign countries that come to it for assistance. It is important to remember that the IMF cannot initiate programs but develops a program for a member country only when that country seeks help. The country is then the IMF's client or patient, but not its ward. The legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions. A nation's desperate need for short-term financial help does not give the IMF the moral right to substitute its technical judgements for the outcomes of the nation's political process." (See Martin Feldstein in "Refocusing the Fund," *Foreign Affairs*, Vol. 77, No. 3, 1998.)

As the size of the IMF and access to its resources have been reduced, a doctrine has emerged whereby the IMF is deemed to act mainly as a catalyst for other resources by putting its seal of approval on country programs.

The Articles of Agreement make no mention of a "catalytic role" for the IMF, nor do they describe it as a credit-rating agency enabling certain countries – but not others – to access international credit markets. This was not the role its founders had in mind when they spoke of promoting international monetary cooperation.

Evidently, the Fund has moved away from Keynes' idea that what we need is a means of reassurance in a troubled world. According to Keynes, no country whose affairs are conducted with due prudence should be held accountable when situations that are not of its own making affect its ability to meet its international liabilities. Rules and restrictions are not necessary *per se*, but as a measure of protection from disruptive outside forces.

(B) The Variables Included in the Proposed Formula

After looking at the history of the quota formulas, how variables affect the calculated quotas under existing formulas, and a number of related issues, and undertaking a substantial amount of econometric work on the factors

that have determined the evolution of quotas and the degree and pace of the convergence of actual-to-calculated quotas, the QFRG decided to take a fresh approach and design a new formula. This formula is supposed “to reflect the underlying changes in the functioning of the world economy and the international financial system, take account of the increasing globalization of markets, and simplify the existing formulas.” (Cooper Report, page 55.)

We recognize that Board discussions have often focused on whether developing countries as a group have sufficient voice in the Fund, and any decisions on the quota formula for the future will have impact on this issue.

However, since our terms of reference do not make any reference to developing countries as a group, we have not taken this aspect into account in recommending a quota formula.” (Cooper Report, page 56.)

The QFRG goes on to state the view that any new formula should have a sound economic basis and should reflect changes in the world economy. Furthermore, the form and content of any new formula should be consistent with the several functions of quotas. The variables contained should not give members incentives to adjust their policies adversely to IMF principles. Any new quota formula should be more transparent and easier to comprehend than the existing set of formulas, and any modification of the quota formulas should be feasible. And finally, where problems of data quality or availability arise, such modification should be contingent on the resolution of these problems. (Cooper Report, pp. 56-57).

The QFRG set about their task by considering two variables that would, in their judgment, best represent 1) the member’s ability to contribute and 2) the member’s need for IMF resources. These are GDP and the variability of export receipts. Let us consider them in turn.

(i) GDP

The work of the QFRG led the group to review the variables included in the formulas and to suggest a welcome simplification of the said formulas. The QFRG agreed unanimously that the most relevant variable for measuring a country’s ability to contribute to the Fund is the country’s GDP. However, the group differed as to how GDP measured in domestic currency was to be converted into a common currency to determine a country’s relative ability to contribute. The majority favored conversion at market exchange rates, averaged over several years, but the minority preferred to measure GDP for

purposes of the quota calculations using PPP-based exchange rates. These members considered that market exchange rates do not necessarily equalize prices of tradable goods across countries, even after taking into account transport costs and quality differences and that this creates an index numbers problem in which the GDP in developing countries is understated in relation to developed countries, if market exchange rates are used.

They noted that while real growth rates in these countries have been significantly higher than in industrialized countries, the expected increase in the relative size of GDP of developing countries is eroded by exchange rate depreciation when converted at market exchange rates (Cooper Report, pp. 57-58).

The majority view argued that while PPP-based conversion rates were appropriate for measuring relative *per capita* income for comparing economic well-being across countries, they were not appropriate for indicating a country's ability to contribute to international endeavors. Second, market prices properly reflect the costs of moving goods from one place to another, and equating prices of equivalent goods regardless of location, as is done in PPP calculations, gives a seriously misleading indicator of the ability to contribute to international undertakings... The IMF is a monetary institution, requiring financial resources for use when members are in financial difficulties in their relations with the rest of the world. A country's ability to contribute is therefore determined by its capacity to provide funds at market exchange rates (Cooper Report, page 58.)

In the view of the majority, PPP-based GDP, as a measure of a country's ability to contribute, would produce serious anomalies suggesting, for example, that China could contribute more than Japan, or that India could contribute more than France. Are these criticisms valid?

While it may be the case that in some unspecified sense the ability of Japan to contribute is greater than that of China, and the ability of France to contribute is greater than that of India, this is not related to the level of international reserves. This variable is excluded "since they may fluctuate from year to year and may reflect international short-term borrowing."

In any event, and contrary to what is suggested, the relationship between actual contributions as determined by quotas and the ability to contribute as a proportion of GDP is very far from a being a binding restriction. First of all, quotas are a very small proportion of GDP, only 1% at the time

of the Eleventh Quota Review in 1998, measured in market exchange rates (Table 1), and an even smaller proportion today. Secondly, since conversions of GDP at market rates produce significantly smaller GDP than PPP-based conversions, the potential contributions by developing countries are such a small proportion of their GDP that the argument loses significance. Thirdly, only 25% of the members' contributions or quotas are paid in foreign convertible currencies. Taken together, these facts weaken the ability-to-contribute argument, the main argument against the use of PPP-based GDP, to the point where it becomes irrelevant. In any case, countries are free to accept or reject proposed quotas, and any country that does not feel able or does not wish to accept an increase in its contribution may decline any proposed increase in its quota.

Moreover, recall that the desire to limit quota increases and to adjust quota shares to changed conditions in the international economy has led the Fund to seek to supplement its available resources by entering into two borrowing arrangements, the GAB and the NAB, with a number of countries in a strong international reserve position that enables them to provide additional financing for Fund operations when required.

Another argument presented against the use of PPP-based GPS is the lack of data. At present, PPP-based GDP estimates are available for only 117 countries, representing 95% of world GDP ... "Of course, with effort, data deficiencies can be eliminated over time." (Cooper Report, page 58.) One might consider that the availability of data for countries accounting for some 95% of the total world GDP is not a bad starting point, if one can work to extend the coverage to other countries, and particularly if one has several years in which to prepare the appropriate estimates.

Recall the situation as regards balance of payments data, prevalent at the time of the Eleventh Review of Quotas, "when data for current receipts and payments through 1994 were used in the quota formulas. At the time balance of payments data supplied for publication in the IMF's Balance of Payments Yearbook were not available for 53 countries (out of the 183 that participated in the quota review). These gaps were filled by information provided by area department desk economists, based on official information, and by staff estimates." (External Review of the Quota Formulas, Annex 7, Balance of Payments Data Used in the Quota Formulas, page 77.) Could not the same be done for PPP-based GDP estimates?

Consider on the other hand, the range of the exchange rate fluctuations and misalignments among major currencies. After all, the exchange rate between the dollar and the Euro has gone from US\$1.18 per Euro to under US\$0.86 per Euro, a variation of 37% in a space of less than two years. This alone would introduce substantial distortions in market exchange rate conversions of GPS measured in these currencies and in others linked to these currencies. The problem is somewhat reduced but does not disappear with the use of three-year averages as proposed in the Report. In the example below, even the use of five-year averages was not sufficient to eliminate significant fluctuations in market rate-based GDP estimates. Contrast these changes with the stability displayed by PPP-based GDP estimates. (See Table 4 below.)

Table 4:
Ratio of Japan's GDP to US GDP

Conversion method	1985	1990	1993	1996
Annual average exchange rate	33	54	67	62
Five-year average exchange rate	39	59	65	61
PPP-based estimate	35	41	41	40

Source: OECD Website "Purchasing Power Parities" quoted in External Review of the Quotas, Annex 5, page 46

Moreover, the well-known shortcomings of market exchange rate-based conversions are magnified in the case of developing and emerging countries, where large devaluations are not the exception. In recent years, these included, *inter alia*, devaluations in Mexico by 115%; in Indonesia by 228%; in Korea by 96%; in Thailand by 87%; and in Russia by 135%. Since large devaluations introduce major distortions in GDP converted at market rates which are only partially – and unevenly – corrected by three year averages, it seems that the majority's argument for the use of market exchange rates for conversions, rather than the use of PPP-based GDP, to avoid the introduction of errors in estimation, is not a solid one. The point has considerable political significance. The GDP of the industrial countries is substan-

tially larger when converted to a common currency in terms of market exchange rates than when it is based on PPP. The opposite is true for the GDP of developing countries. To visualize the importance of the differences simply consider the following table:

Table 5:

Comparison of PPP-based GDP and Exchange Rate-based GDP of Selected Countries in 1994

Country	Share of World total		Rank	
	PPP	ER	PPP	ER
US	21.5	26.7	1	1
China	8.8	2.1	2	9
Japan	8.5	17.8	3	2
Germany	5.2	7.9	4	3
India	3.9	1.2	5	15
Russia	3.1	1.0	9	16
Brazil	3.1	2.9	7	10
Mexico	2.0	1.6	11	12
Netherlands	0.9	1.3	22	13
Indonesia	1.7	0.7	14	23

Source: External Review of Quota Formulas, Annex 5, EBAP/00/52, Supplement 1

The main reason for this difference is that the use of market exchange rates substantially undervalues the GDPs of developing countries. This is because in developing countries the prices and wages prevailing in the tradable goods sector are higher than those prevailing in the non-tradable goods sector, a phenomenon that is not of significance in developed countries. As the non-tradable sector represents a substantial part of the economy, the valuation of this sector at market exchange rates pulls down the valuation of this sector, and therefore of GDP as a whole below its valuation at PPP-based rates. This represents a major distortion inherent in the market exchange rate-based GDP which would argue against its use in GDP comparisons between developed and developing countries. Since

PPP-based GDP estimates, on the other hand, are much more stable and do not introduce a measurement bias against any group of countries, they would appear to be preferable for this purpose.

In any event, to the extent that GDP is a major determinant of quotas, when the method of GDP conversion is chosen, the distribution of quotas is substantially determined. Since the weakness of the available PPP-based GDP data in some countries is no worse than that of some of the other data used in the calculations, the decision should be to work toward its improvement rather than to abandon the concept. There are very large discrepancies between GDP estimates based on market exchange rates and those PPP-based estimates, but if all estimates have statistical problems and one measure favors one group while another measure favors a different group, would it not be reasonable to at least consider using both measures and perhaps averaging them?

(ii) The Variability of Receipts

In looking at the members' potential need for financial support from the Fund, the QFRG finds that the single most relevant variable for measuring a country's vulnerability to external disturbances is the variability of its international receipts.

The variability of international receipts is proposed to be measured as the standard deviation from trend of *current account* receipts over a 13-year period, with the trend measured by the centered five-year moving average. The Report admits the possibility of refining this variable "by adding to receipts some measure of autonomous net inflows of capital, e.g., net long-term borrowing plus foreign direct investment, assuming that reasonably accurate information was available on a timely basis." While these are undoubtedly relevant variables, and this is the traditional way of looking at balance of payments vulnerability, they are not the whole story. In looking at external vulnerability, one may consider

- the degree of openness of an economy;
- the composition of exports;
- the concentration of exports; and
- the dependence on external financing, particularly on short-term capital flows.

The first of these variables, the degree of openness, may be measured by the sum of imports and exports as a proportion of GDP. Obviously, a closed economy, where, for example, the external sector accounts for 6% of GDP, will be less affected by external developments than a very open one, where the external sector accounts, for say, 50% of GDP. In the first case, a collapse of exports will have a limited impact on the level of domestic economic activity, while, in the second case, an export collapse will have major consequences in terms of output and employment. Thus, since an open economy is more vulnerable than a closed one, the degree of openness should be seen as a separate variable, to be distinguished from the variability of current receipts. This variable is not considered by the QFRG.

As is well known, export composition is an element of vulnerability, since exports of commodities are subject to greater price fluctuations than exports of manufactured goods. Thus, a country with a high concentration of exports in one or two primary products, such as cocoa, coffee, or copper, is subject to wide fluctuations in export revenues.

Similarly, the concentration of exports in one or two markets whether of manufactures or primary products will result in substantial cyclical variations in export revenues and in a high degree of vulnerability for the exporting country. While these well known factors are not mentioned explicitly by the QFRG, only the second and third can be subsumed in the proposal for the measurement of variations in current revenues.

However, trade variables cannot open the way for the consideration of the major financial crises that have dominated the Fund's financial operations in recent years. Excluded from consideration by the QFRG is the member's dependence on international financial markets, particularly the *volatility of short-term capital flows*, which, as is widely recognized, has been the determining factor in the financial crises suffered by emerging market economies over the past few years.

Recall that the terms of reference explicitly refer to "changes in functioning of the world economy and the international financial system in the light of the increasing globalization of markets." Since the increasing role of financial markets and the technological revolution that made their globalization possible are probably the single most important change that has taken place in the international economy, it is surprising that although explicitly referred to in the mandate to the group, the variables proposed

focus on current account receipts. While admitting the possibility of including long-term capital flows, the QFRG excluded the consideration of short-term capital movements, whose reversal has played the major role in the balance of payments difficulties of emerging markets in recent years.

7. On Reforming the Governance of the Fund

As has become clear, the governance of the Fund falls short of its own standards and recommendations in terms of transparency and accountability. Transparency requires that decisions be the result of open discussions with broad participation. Accountability requires that those taking decisions face up to their consequences. Legitimacy requires that the views and interests of all IMF members, which are mostly developing countries and economies in transition, be given appropriate consideration.

International institutions must reconcile countries' own political objectives with the wider interests of the international community. These objectives will not be attained as long as decisions are taken by a very small group of industrial countries, the G-7, meeting outside the IMF. Furthermore, the current power structure, which places a single country in a dominant position, impairs the accountability of the Fund for its decisions and recommendations. Is a reform of the governance of the Fund possible? Or rather, to what extent will the Fund be reformed? In recent years, criticism of the Fund's handling of the Asian crisis has increased, and reform proposals have gained ascendancy. Many economists thought that the Fund had aggravated the crisis by imposing inappropriate policies, or "remedies" which were worse than the disease itself. They pointed out that the Fund had worsened the crisis by insisting on fiscal retrenchment in the midst of a recession and by imposing structural conditions that were not relevant to the solution of the balance of payments problems. Many observers in developing countries have regarded the Fund as US-dominated since its inception: with its headquarters in Washington and the Deputy Managing Director always an American, it is often seen supporting US political and economic interests abroad by imposing austerity on developing countries to protect the interests of western creditors. On the conservative side, the Meltzer Report castigated the Fund for fostering moral hazard by bailing out private investors in emerging markets with large injections of money, thereby absorbing the losses arising from bad investment decisions.

Although these criticisms have created a climate of opinion that favors reform, the political difficulties that prevented reform in the past remain. They involve overcoming the vested interests and the resistance of major industrial countries to give up control, and of certain others to give up certain “acquired rights,” particularly in regard to voting power and representation at the Executive Board. Nevertheless, there is a clear perception among senior officials, both in developing and in industrial countries, that some measure of reform is necessary, indeed indispensable, to secure the legitimacy of the Fund’s decisions and the countries’ ownership of programs required by the improved operation of the institution. The current discussions on the reform of conditionality and the recent creation of an Office of Independent Evaluation in the Fund may be seen as a reflection of this realization.

Reform is also required *inter alia* to increase transparency of decision-making and in appointments to senior positions, as well as to give a voice in policy discussions to certain groups of virtually disenfranchised countries, particularly the African and other low income countries.

The increased participation of borrowers in decision-making is increasingly perceived as essential for the ownership of Fund programs and required for their success. Frequent informal staff contacts and discussions with developing country executive directors and officials to improve understanding of their concerns, in a manner parallel to ongoing contacts with officials and directors from major industrial countries, may also be necessary.

What elements should a reform of the governance of the Fund include? While the reform of the Fund is a highly political subject, experience suggests that for it to be successful certain objective elements should be kept in mind. The following suggestions are put forward to contribute to the discussion of the subject.

(i) Restructure the Executive Board.

The representation at the Board could be regulated so that an increase in the number of directors representing developing countries would be accompanied by an equal reduction in the number of directors from industrial countries. The region with the greatest number of representatives at the Board is Europe, which currently holds eight or nine chairs. Thus, Europe is the obvious candidate for a reduction in the number of the chairs it holds. An additional reason for suggesting a reduction in the

number of European directors is the existence of a 12-country monetary union that now has a common currency and a common interest- and exchange-rate policy *vis-à-vis* the rest of the world. While one might consider having all members of the European Monetary Union represented by one director, it would suffice to reduce the number of directors to perhaps two or three from the European Union, half of the current number. Couldn't Belgium, Luxembourg, the Netherlands and the Scandinavian countries be represented by one director instead of three? Couldn't France and Germany share a director? Of course, this would require a reshuffling of existing constituencies.

In order to be able to give adequate attention to the needs of the countries he/she represents, no executive director should represent more than twelve to fifteen countries. In addition, the staff in the offices of executive directors who represent more than one country should be strengthened significantly, in proportion to the number of countries represented. These measures would permit directors representing large constituencies to play a more active and effective role in policy discussions.

Although increased voice at the Board for developing countries is important, it is not sufficient by itself. This writer recalls occasions when a major industrial country refused to engage in the discussion of an issue that it could lose on logical grounds. The directors would simply state that, after listening to the arguments, they had not changed their position on the issue.

(ii) Protect the Rights of Minorities.

Recently, the idea of applying certain principles of corporate governance to protect minority rights in international financial institutions has elicited growing interest. These principles would seek to ensure a minimum of transparency and of voice, or participation, in certain decisions, as well as to ensure that members seeking financial support receive a certain protection against excessive demands by the Fund. Prominent among the ideas that have been put forward are certain principles the developing countries had incorporated in the "Guidelines on Conditionality," adopted by the Fund in 1979. These include the following points:

- In helping members to devise adjustment programs, the Fund will pay "due regard" to the domestic social and political objectives, the economic priorities, and the circumstances of members..." (The developing countries argued for the word *respect* instead of *due regard*.)

- A member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, “only if necessary to enable the member to adopt and carry out a program consistent with the Fund’s provisions and policies.”
- “The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring achievement of its objectives.”
- Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them.

The important corporate governance notions of external auditing, transparency and accountability of Fund operations, particularly at country level, were also contained, to an extent, in the following requirement:

- “The staff will from time to time prepare, for review by the Executive Board, studies of programs supported by stand-by arrangements in order to evaluate and compare the appropriateness of the programs, the effectiveness of the policy instruments, the observance of the program and the results achieved.”

It has often been felt that the Fund should improve its own record on transparency and accountability for policy mistakes. The application of principles of corporate governance to the BW Institutions seems to offer a promising approach that merits further discussion, leading to the elaboration of certain widely accepted principles. The process will take time. Perhaps the main limitation faced by the application of principles of corporate governance in the BW Institutions is that whereas in a corporate context, a minority shareholder who feels his rights have been trampled on may seek a remedy at a court of law, in the context of international institutions, there is no judicial remedy. In this case, the injured party can only resort to political fora, whose neutrality may be questionable, such as the Executive Board, and where the existing power structure may or may not provide an appropriate remedy.

It is clear that despite the injunctions of the Guidelines on Conditionality, the scope and nature of the Fund’s conditionality has grown during the past two decades, prompting concerns that it was “overstepping its

mandate and core area of expertise, using its financial leverage to promote an extensive policy agenda and short-circuiting the national decision-making processes.” In spite of the Guidelines on Conditionality, the number of performance criteria, particularly structural conditions unrelated to macro-economic performance, has also increased in an unprecedented manner. This suggests that given the power structure of the Fund, in the absence of a court of law or a quasi-judicial procedure to enforce them, the existence of guidelines or principles, while necessary, is not sufficient to attain the desired protection for the rights of smaller members.

(iii) Revise Quota Formulas.

Turning to the more technical aspects of the reform, the QFRG has made us consider the relevant issues involved in the revision of the quota formulas and reflect on what variables are appropriate and should be included. Despite the shortcomings of the proposed formula, the initiative posited by the QFRG for simplifying and increasing the transparency of the quota formula has considerable merit and should be accepted. Moreover, much of the historical and analytical background material may also be useful.

Some suggestions for improving the proposed formula by addressing its main shortcomings are presented below:

- (a) Relate overall quotas to world trade and capital movements, or to world GDP. A first approach would be to ensure that the size of the Fund should not fall below an agreed proportion of world trade, or of world GDP. Note that simply establishing a ratio of, for example, 15% of imports would more than double the Fund’s resources, enabling it to reduce the costs of adjustment to members and making the institution far more relevant to their problems. Total quotas could be adjusted more or less automatically at three-year intervals to keep them from lagging significantly behind the expansion of the international economy. Additionally, total capital flows to prospective borrowing countries, all Fund members except for some 22 industrial countries, could also be considered in determining countries’ potential need for IMF support. (This would not preclude any industrial country from turning to the Fund for support.)
- (b) Restore the role of basic votes to their original function. This should lead to increasing them to an agreed proportion of total voting rights, for example, 20% of the total, and provide that in future, basic votes will in-

crease in the same proportion as total quotas. The increase in the share of basic votes, since it favors smaller members and reduces the relative position of the larger economies, is a potentially divisive issue for the developing countries themselves. To be acceptable to the developing countries as a whole, the increase would have to be part of a package accompanied by a significant increase in the quotas of the larger economies, through the revision of the quota formulas to include PPP-based GNP estimates.

(c) Use PPP-based GDP estimates in the quota formulas in order to avoid the current under-estimation of the economic size of the developing countries and emerging market economies, and their ability to contribute. This should also correct their under-representation at the Board. Increasing the stake of developing countries in the Fund should also raise their contribution and lessen the concern of current creditor countries over the risk of Fund credits.

(d) Include additional elements in the variable that measures the external vulnerability of countries. The inclusion in the quota formula of a measure of the openness of the economy and of the dependence of a country on international financial markets would appear to be necessary.

While the major shortcomings of the proposed formula could be overcome with these simple technical changes, the determination of quotas is as much a political as a technical exercise, and no amount of technical work can take the place of the political discussions and eventual negotiations that are necessary to reach a broad agreement.

(e) Increase basic votes. As explained above, successive quota increases have eroded the position of smaller countries with respect to what the BW Articles of Agreement had contemplated. As a result of the 37-fold increase in the size of quotas, the significance of basic votes has been reduced out of all proportion, which has led to the decline in the influence of smaller countries. It is desirable, therefore, from the standpoint of equity, to increase the number of basic votes per member country.

8. Final Considerations

Will the G-7 and the other industrial countries that enjoy a privileged position be prepared to yield part of their power to the broader membership of the Bank and the Fund?

There are sound political and economic reasons for their doing so. Much has changed in the political map of the world since 1945. When a number of former colonies became sovereign countries, and the Soviet Union gave way to a number of independent economies in transition, the membership of the Bank and the Fund expanded from 45 to 183 countries.

The structure of the world economy has also changed considerably since the Bretton Woods Conference of 1944: the developing countries now account for a growing share of the world's output and trade, with China, India, Brazil and Mexico among the world's ten largest economies, measured in real terms. At the same time, other newly industrialized countries are overtaking others as major economic players, without attaining adequate representation in the Bank and the Fund. The Soviet Union has disappeared. Trade has grown beyond expectations, and as official flows have declined, the growth of private international financial markets, made possible by information technology, has been explosive. Vastly expanded international capital markets have taken a major unforeseen role, giving rise to new opportunities and challenges.

Because these political and economic changes have not been appropriately reflected in the decision-making structure of the Fund, this structure has become dysfunctional, and the governance of the Fund and the legitimacy of Fund decisions have been increasingly questioned. Too often, the member countries see programs more as inevitable impositions, aimed at serving the economic and political interests of other parties, rather than as the result of an exercise in monetary cooperation, in which their full participation gives them a sense of ownership. It is hardly coincidental that while the need for support of a significant group of developing countries has risen, the size of the Bank and the IMF has shrunk relative to world trade, and even more so in relation to international capital movements.

For more than twenty years, the Fund's operations have been conducted exclusively with developing countries. Recently, it has also dealt with the countries in transition. Moreover, in recent years, the Fund has extended its conditionality to issues of governance. This situation has widened the divide among IMF members. On the one hand, there is a small group of creditor industrial countries with a majority vote; on the other, there is the large number of mainly debtor developing countries with a mi-

nority vote and limited influence on policies. Consequently, decisions on major Fund support programs are often taken outside the Fund, on a discretionary basis, without rules. This power distribution raises questions on the legitimacy, transparency and accountability of Fund governance.

The smooth functioning of the Fund would seem to require a balance between the different interest groups. Therefore, a point of departure for the necessary negotiation leading to the re-apportionment of quotas and the revision of basic votes could be an agreement that the groupings of industrial and developing countries, or of potential debtor and creditor countries should each have about half of the total vote at the Board. A further stage could be the revision of quota formulas, particularly the weight to be given to GNP (measured by PPP) and other variables. But since it would be difficult to come to an agreement on quota formulas without reference to what would happen to the determination of the share of basic votes in the total, this might have to be a simultaneous exercise.

Over the past twenty years, countries' access to IMF resources has become less predictable, conditionality has gradually become more restrictive even for the compensatory financing facility, and SDR allocations have been suspended. These are manifestations of the growing gap between prospective debtor and creditor countries and of the corresponding change in the industrial countries' view of the IMF. The industrial countries no longer regard the IMF as the center of the international monetary system, but treat it instead as a specialized agency for assisting the developing countries. Therefore, the availability of sufficient support cannot be relied on. With this approach Keynes would disagree: "This [the Fund] is not a Red Cross philanthropic relief scheme, by which rich countries come to the rescue of the poor," he declared, but "a piece of highly necessary business mechanism which is at least as useful to the creditor as to the debtor."⁵

5. David Finch, former director of the Exchange and Trade Relations Department, which is responsible for ensuring the coherence of adjustment programs and equal treatment of member countries, resigned under political pressure to relax IMF conditionality for Egypt and Zaire ("IMF Silent on Resignation," *Financial Times*, March 21, 1987.) Other well-known cases of geo-political considerations determining support for poor programs were support for Argentina in the second part of the 1980s and for Russia in the 1990s. See also Bordo, M.D. and James, H. in "The International Monetary Fund: Its Present Role in Historical Perspective," NBER, W.P. 7724, June, 2000 and Krueger, Anne O. in "Whither the World Bank and the IMF?," NBER W.P. 6327, Dec. 1997.

In the face of the major changes that have taken place in the economic and political panorama of the world, a more representative and transparent decision-making process is required to enhance the democratic legitimacy of an institution so involved in the economic governance of its members.

The concentration of power in the hands of a very few countries also impairs the adjustment process between deficit and surplus countries. Although the IMF can bring considerable pressure to bear on the economic policies of the developing countries seeking financial assistance, it cannot induce the largest deficit country to reduce its national debt. Does it make sense for the richest country in the world to be the biggest debtor? Nor does the IMF require surplus countries to reduce their external imbalances.

The pressures of short-term self-interest and expediency appear to have blurred the Bretton Woods vision of international cooperation as a means for improving the workings of the world economy. The notion that national goals are often best attained through international cooperation tends to be forgotten. This situation is unsatisfactory. To improve the governance of the Fund in terms of participation, transparency and accountability, and to enable it meet the new challenges of the world economy will require a major reform of the quota and decision-making structures.

If globalization is to work for all countries, the success of the Fund as a multilateral institution is crucial. Democratic legitimacy and participation are not contrary to the strict application of sound policies and clear principles in the exercise of the Fund's competencies.

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Financing for Development: Trade and Finance Issues

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Abstract

Trade liberalization for developing countries, its benefits and costs, has become a controversial issue. The outcome of the debate has serious implications for trade policy at national and international levels. The orthodox theory suggests that trade liberalization has positive and almost automatic links to economic growth and development. However, in the past two decades, corresponding to the period of rapid import liberalization in developing countries, only a few countries have enjoyed moderate or high growth while the majority has actually suffered declines in living standards. Trade liberalization has often caused imports to grow faster than exports, whereby the price and quantity of the latter is not under the control of national authorities. The results are obvious: countries that liberalize often face persistent trade deficits and become prone to balance-of-payments difficulties, with consequences in terms of indebtedness, changes in exchange rates, and national income. The paper calls for introducing measures to redress the balance towards the developing countries, and argues that developed countries should commit to meaningfully opening their markets to developing countries in sectors, products and services in which the latter are able to benefit. In particular, there should be a re-orientation in the operational principles and rules of the WTO so that the development principle is accorded the highest priority. Meanwhile, the developing countries, with the help of the international community, should make greater efforts to improve their capacities and the conditions for successful trade. Moreover, they should take a more active role in stabilizing and arresting the deterioration in the prices of their major commodities.

Trade, Development and Finance Links

Trade and Development

Trade and trade liberalization for developing countries, its relative benefits and costs, has become a controversial issue. The conventional view that trade liberalization is necessary, and that it has automatic and generally positive effects for development, is now being challenged empirically and analytically. This debate has serious implications for trade policy at national and international levels.

The orthodox theory is that trade and trade liberalization have positive and almost automatic links to economic growth and development. Thus, a key, and even essential aspect, in achieving successful development is for developing countries to open themselves to trade. This theory is still dominant, and has been powerfully put into operation through the structural adjustment programs of the Bretton Woods Institutions, and by the rules and dominant approach of the World Trade Organization (WTO).

According to the theory, a country that liberalizes its imports can achieve greater consumer welfare and production efficiency. Cheaper imports increase consumer access to products. Local firms facing greater competition will become more efficient, and those that do not, will close down. Resources, including labor, can then be shifted to the production of goods in which local firms have a comparative advantage. Ideally, these firms can then produce for export markets and obtain export revenues that will bring higher incomes than if the firms had continued to produce inefficiently for local markets. Thus, there is a net income gain.

The notion that everyone gains and no one loses in trade liberalization has proven to be overly simplistic. In the past two decades, which correspond to the period of rapid import liberalization in developing countries, only a few countries have enjoyed moderate or high growth while a majority of countries has actually suffered declines in living standards (measured in *per capita* income). The *Human Development Report 1999* of the United Nations Development Program (UNDP) showed that only 33 countries had managed to sustain 3% annual growth during 1980-1996, and that in 59 countries (mainly in sub-Saharan Africa, Eastern Europe and the Commonwealth of Independent States) GNP *per capita* had declined.

The Report stated, “Economic integration is thus dividing developing and transition economies into those that are benefiting from global opportunities and those that are not” (UNDP, 1999: 31.)

In contrast to orthodox theory, in reality, many local firms in developing countries have been unable to compete with a flood of cheaper imports arising from import liberalization and have closed. At the same time, developing countries face a number of constraints on the expansion of their exports:

- the prices for commodities, their main export items, have been declining continuously;
- there are protectionist barriers, especially in developed countries, against products of interest to developing countries (for example, tariff peaks and tariff escalation, that prevent a higher growth of exports of processed natural resource-based products; continued high protection in agriculture and textiles; and non-tariff barriers such as anti-dumping measures and safety standards);
- there are structural, supply and marketing constraints in many developing countries that prevent the growth of corporate enterprises and of their production and export capacity;
- the new rules in the WTO on TRIMs, subsidies and TRIPS make it more difficult for developing countries to take the industrialization route (or elements of it) that successful industrializers used in earlier periods;
- an alternative to exports arising from local firms is export-led growth prompted by foreign investments. However, few developing countries have been able to attract foreign direct investment (FDI) for this purpose. Even if developing countries were to generally become attractive to FDI, there may not be sufficient volume of FDI worldwide to play the role of export-led growth or employment generator in developing countries.

Countries exposed to trade openness do not automatically enjoy a balanced increase in the rates of imports and exports. For many developing countries, imports have surged under import liberalization policies, while exports have not enjoyed a corresponding rise, which has led to increased trade deficits and balance-of-payments difficulties (see Section A.2 below for a more detailed discussion of this point). The increase in imports can displace local production and employment at a steeper degree than any increase of output, jobs or income resulting from increases in exports.

Given the reality faced by many developing countries, it should be no surprise that there is no automatic link between trade openness and growth, or development. Some recent studies have shown there is no automatic correlation between trade liberalization and growth. Countries that rapidly liberalized their imports did not necessarily grow faster than those that liberalized more gradually, or in more strategic ways.

For example, in a study of 41 least developed countries, the UN Conference on Trade and Development (UNCTAD) senior researcher Mehdi Shafaeddin (1994) found

no clear and systematic association since the early 1980s between trade liberalization and devaluation, on the one hand, and the growth and diversification of output and growth of output and exports of LDCs on the other. In fact, trade liberalization has been accompanied by de-industrialization in many LDCs, and where export expanded it was not always accompanied by the expansion of supply capacity.

By contrast, the paper attributes success or failure of GDP and industrial growth to the volume of investment and availability of imports. "The design of trade policy reforms has also been an important factor in performance failure."

Dani Rodrik (1999) argues that developing nations must participate in the world economy on their own terms, not the terms 'dictated' by global markets and multilateral institutions. Noting the premise that reducing barriers to imports and opening to capital flows would increase growth and reduce poverty in developing countries, Rodrik's study concludes

[t]he trouble is, there is no convincing evidence that openness, in the sense of low barriers to trade and capital flows, systematically produces these results. The lesson of history is that ultimately all successful countries develop their own brands of national capitalism. The States which have done best in the post-war period devised domestic investment plans to kick-start growth and established institutions of conflict management. An open trade regime, on its own, will not set an economy on a sustained growth path.

Effect of Trade Liberalization on Trade Deficits

An issue which is a direct linkage between trade and finance is the effect of trade policy and reform on trade deficits in developing countries. The link is obvious: countries with persistent (or increasing) trade deficits are

prone to getting into balance-of-payments difficulties, with consequences in terms of indebtedness, changes in exchange rates, and national income.

As the previous section (A.1) discussed, trade liberalization can lead to adverse results if there is an imbalance between the rates of growth of imports and exports. UNCTAD's *Trade and Development Report 1999* has dwelt at some length on the deterioration of the trade balance for many developing countries. The report found that for developing countries (excluding China) the average trade deficit in the 1990s was higher than in the 1970s by 3 percentage points of GDP while the average growth rate was lower by 2 percentage points. In discussing why trade deficits have been increasing faster than income in developing countries, the report concludes

[t]he evidence shows that a combination of declining terms of trade, slow growth in industrial countries and 'big bang' liberalization of trade and of the capital account in developing countries has been a decisive factor (UNCTAD, 1999a: Chap. VI).

On the role of rapid trade liberalization in generating the wider trade deficits, states the UNCTAD report:

It [trade liberalization] led to a sharp increase in their import propensity, but exports failed to keep pace, particularly where liberalization was a response to the failure to establish competitive industries behind high barriers. With the notable exception of China, liberalization has resulted in a general widening of the gap between the annual growth of imports and exports in the 1990s, but the impact was particularly severe in Latin America, where the gap averaged about 4 percentage points.

As pointed out in Section A.1, a major problem faced by developing countries in the trade liberalization process is that a country may be able to control how fast to liberalize its imports (and thus increase the inflow of products) but cannot determine by itself how fast its exports grow. As the conditions for export growth have not been favorable, while imports have increased significantly due to liberalization, there has been a resulting increase in the trade deficit in many developing countries.

An important conclusion is that if trade liberalization is carried out in an inappropriate manner in countries that are not ready or able to cope with it, or which face unfavorable conditions, it can contribute to a vicious cycle of trade and balance-of-payments deficits, financial instability, debt and recession.

Effects of Financial Instability and Crisis on Trade

While trade performance has an important effect on finance (including through the balance of payments), a country's financial situation also has an important effect on its trade. Several developing countries in recent years went through financial crises that were catalyzed not so much by their trade performance as by autonomously-generated capital flows. These "capital account crises" arise from sudden, large withdrawals of capital (foreign credit, foreign portfolio capital, and/or local savings), often following an earlier period of large inflows. The capital outflows are often accompanied by steep devaluation of the currency and a high increase in interest rates (the latter being an attempt to stem the capital outflow and reduce the rate of devaluation). The devaluation increases the external debt burden while the interest rate hike increases the domestic debt burden.

The financial crisis puts pressure on the ability of the affected country to import as a result of the following mechanisms: (a) the capital outflow reduces the level of foreign reserves, and thus the country has a shortage of foreign currency with which to import; (b) the currency devaluation adds to the burden of external debt servicing, thus diverting local financial resources from consumer or investment expenditure to debt service; (c) the devaluation also makes imports more costly, and thus results in reduced import volume; and (d) the recession in income induces a reduction in the demand for imports.

The fall in demand for imports in the affected countries also impacts on their trading partners. For example, during the recent financial crisis involving East Asia and Russia, there was a reduction in the demand for and the prices of commodities, thus affecting commodity-exporting developing countries. Thus, global financial instability affects the trade of countries directly involved in the financial crisis as well as other countries, and the overall growth of global trade can also be affected.

The links between financial crisis and a dampening of trade point to the need to regulate the global financial system so as to reduce the risks of financial volatility and crises and thus avoid the negative trade effects.

Proposals

(a) There should be a review of orthodox trade policy and its assumption of the automatic benefits of trade liberalization and the desirability of rapid, “big-bang” liberalization. Focus should be put on the conditions for successful liberalization, and the implications if such conditions (or some of them) are not present. Thus, the focus of trade policy should be put on the quality, timing, sequencing and scope of liberalization (especially import liberalization), and how the process is accompanied by (or preceded by) other factors such as the strengthening of local enterprises and farms, and human resource and technological development, as well as the build-up of export capacity and markets. A logical conclusion must be that if conditions for success are not yet present in a country, then proceeding with liberalization can lead to specific negative results or even a general situation of recession. Thus, to pressurize such countries to liberalize would be to lead them into an economic quagmire.

(b) The International Monetary Fund (IMF), the World Bank and other multilateral and regional credit and aid agencies should review their conditionalities on trade. They should not take the approach of pressurizing developing countries to rapidly liberalize their imports, but instead take a comprehensive view, including whether local enterprises and farms are already capable of competing with cheaper imports, whether there are sufficient export opportunities, and if the supply conditions already exist that the country needs to realize the opportunity of market access. Priority should be put on assisting countries in building the capacity and the conditions for successful trade.

(c) The operating principles of the WTO should be re-oriented towards the development of developing countries, instead of achieving maximum liberalization and deregulation of markets in developing countries. This requires an understanding of the conditions and measures required for development, and these measures should be permitted by the WTO rules, if necessary through exemptions under the special-and-differential-treatment principle. The goal of seeking to remove measures or policies that are “trade-distorting” or “free-market distorting” should be balanced by the principle of enabling countries to maintain or introduce measures and policies that are “development-required.” Thus, policies that may be “trade-distorting” but

which are “development-required” should be permitted. Existing rules in the WTO should be screened as to whether they meet this “development principle” and appropriate reforms should then be carried out.

(d) A review of the existing policy conditionalities of the multilateral banks and aid agencies, and of the WTO rules should be conducted to see whether and how they may be contributing to the structural trade deficits of developing countries. Those policies and rules that are inappropriate in this context should be amended accordingly.

(e) Caution must be exercised when considering proposals for new measures that would bind developing countries to undertake policy changes that are likely to result in further import liberalization (without the likelihood of corresponding export expansion). Such new measures may result for example from the new proposals in the WTO to start another round of industrial tariff cuts, and to integrate government procurement in the WTO system.

(f) Imbalances and inequities in the world trading system should be tackled as a priority. In doing so, developed countries should increase the access of products from developing countries to their markets, so that the latter can have the opportunity to increase their exports and thus to improve their negative trade balances. However, developing countries should be allowed greater flexibility to choose their own rate of trade liberalization.

(g) The implications for trade of financial instability and volatility (caused by liberalized flows of capital) should be studied in greater detail, and measures should be taken at the global, regional and national levels to curb such financial instability so as to avoid negative trade effects.

Terms-of-Trade Shocks and the Capacity to Save and Invest

Analysis

The adverse terms of trade affecting most developing countries have pre-occupied the minds of many economists and policy makers. The issue has traditionally been seen as the fall in the terms of trade of commodity prices *vis-à-vis* the prices of manufactured goods. Since the major exports of most developing countries comprise commodities, while their major imports

have been manufactures, the changes in relative prices between commodities and manufactures have resulted in declining terms of trade for developing countries on average.

Between the 1960s and the 1980s, attempts to stabilize commodity prices at reasonable levels were, in fact, among the most important international initiatives in the trade arena. However, these efforts, mainly through UNCTAD, have greatly diminished as the commodity agreements that were their hallmark have become less effective, and several have closed. The failure of commodity agreements was contributed to by the withdrawal of interest and commitment by the consumer countries. As a result, commodity prices are now mainly determined by the vagaries of supply and demand of market forces.

The serious downgrading of the commodity problem in the international agenda is unfortunate, since the problem has not gone away, but instead has remained just as serious, if it has not become more so. A large number of developing countries are still dependent in their exports on a few commodities. For them, the most important trade issue is the continuing decline in the terms of trade for their commodity exports *vis-a-vis* their imports of manufactures. While this problem no longer gets the high priority it used to in UNCTAD, it is also hardly discussed at all in the WTO. Yet the decline in terms of trade for developing countries has generally become more acute in recent years, and has been responsible for the transfer of a huge volume of real resources from commodity-exporting developing countries through the mechanism of income losses arising from terms-of-trade changes.

The United Nations used to publish annual data on the income effects of changes in the terms of trade for developing countries and for commodity-exporting countries, for example in the annual *World Economic Survey*. However, such data have not been available on a regular basis in recent years.

According to UN data, the terms-of-trade of non-fuel commodities *vis-a-vis* manufactures fell from 147 in 1980 to 100 in 1985 to 80 in 1990 and 71 in 1992. This sharp 52% fall in the terms of trade between 1980 and 1992 had catastrophic effects. A paper published by the Secretariat of the United Nations Conference on Environment and Development (UNCED) in 1991 showed that for sub-Saharan Africa, a 28% fall in terms of trade between 1980 and 1989 had led to an income loss of

US\$16 billion in 1989 alone. In the four years 1986-1989, sub-Saharan Africa suffered a US\$56 billion income loss, or 15-16% of GDP in 1987-1989. The UNCED study also showed that for 15 middle-income, highly indebted countries, there was a combined terms-of-trade decline of 28% between 1980 and 1989, causing an average loss of US\$45 billion per year in the 1986-1989 period, or 5-6% of GDP (Khor, 1993).

Data on income losses due to terms-of-trade decline on such a systematic level as in the above have not been forthcoming since the early 1990s. This is unfortunate as even these outdated figures indicate the seriousness of the situation.

In 1989, gross domestic saving was 15.8% of the GDP of African countries as a whole, and the gross domestic investment rate was 20.4% of GDP (United Nations, 1992: 195). As mentioned above, sub-Saharan Africa suffered a loss of income due to terms-of-trade decline equivalent to 15-16% of GDP in 1987-89. Taking the 1989 Africa savings rate as the reference, it can be concluded that sub-Saharan African countries in the late 1980s were losing income equivalent to the amount of their entire savings level, as a result of terms-of-trade decline. If the terms of trade had not declined, and if the income lost had been added to savings, then the value of savings could have doubled. If the savings had all been invested, the investment level in the region would have increased by 76%. These tremendous increases in savings and investments could have contributed to significant increases in the overall rates of economic growth. Of course, if the terms of trade had actually remained stable, and the extra revenue had accrued, it would be unrealistic to expect that all of it would have been saved and invested. But even if only a part of the extra income had been channeled to savings and investment, it would have had a tremendous positive effect on growth and development. And those revenues that would have been channeled to consumption could have increased the people's welfare and eased the plight of the poor.

The data also indicate that terms-of-trade decline is probably the most important single factor responsible for the net transfer of financial and real resources from the developing countries. A stabilization or, better still, a reversal of the terms-of-trade decline would enable developing countries to significantly improve the mobilization of domestic resources for savings, investment and growth.

As pointed out, the data on terms of trade and income losses associated with it, at such a systematic level, have not been available for some years from the UN publications in which they traditionally appeared. However, data from other sources show that the situation has in fact worsened in recent years.

In the 1990s, the general level of commodity prices fell even more in relation to manufactures, and many commodity-dependent developing countries have continued to suffer deteriorating terms of trade. According to UNCTAD's *Trade and Development Report, 1999 (TDR 99)* (UNCTAD, 1999a: 85), oil and non-oil primary commodity prices fell by 16.4 and 33.8% respectively from the end of 1996 to February 1999, resulting in a cumulative terms-of-trade loss of more than 4.5% of income during 1997-1998 for developing countries. "Income losses were greater in the 1990s than in the 1980s not only because of larger terms-of-trade losses, but also because of the increased share of trade in GDP." Moreover, the prices of some key manufactured products exported by developing countries have also declined. For example, the Republic of Korea experienced a 25% fall in the terms of trade of its manufactured exports between 1995 and 1997 due to a glut in the world market (UNCTAD, 1999a: 87).

The above discussion shows that the world trading system has been favoring the exporters of manufactured goods, while proving to be disadvantageous to the many developing countries whose main participation in global trade has consisted in the export of raw materials and commodities and the import of finished products. Many Southern countries have also lost their self-reliance in terms of producing their own food, as lands were converted to farm export crops that in many cases yielded unsatisfactory results in terms of instability of price and demand.

As pointed out earlier, the attempts made by developing countries to obtain fairer prices and more stable demand conditions for their commodities through commodity agreements involving producer and consumer countries, have mainly failed as the industrial countries, which are the main consumers of commodities, withdrew their support in the 1980s.

With oversupply of many commodities, stagnating demand, and trend decline in prices, many of the developing countries still dependent on commodity exports have been trapped in a bad corner of the world trading system.

The commodities situation may worsen for developing countries should major consumer countries (in the North) develop laboratory substitutes for natural commodities through the use of biotechnology. That would cause even more displacement of the South's export commodities.

In recent years, it is not fashionable to discuss or consider the role of international commodity agreements, involving both producing and consuming countries, in the stabilization of commodity prices and in rationalizing supply to make it correspond to demand. However, the difficulties encountered in commodity agreements arose more from political factors, such as the loss of will and interest by major consumer countries, than from any intrinsic or inherent weakness of such agreements. If there is a revival of political will, especially among the developed countries, there can be a fresh attempt to make use of such agreements as instruments to resolve the developing countries' commodity-exports problems.

In the absence of producer-consumer cooperation and agreements, commodity producers may have to rely on cooperation among themselves to ensure stable and reasonable prices. The example of oil is instructive. The ability of major oil exporters through the Organization of Petroleum-Exporting Countries (OPEC) to work out among themselves a system of coordinating the overall output level and also the respective levels of each member has led to a revival of the price of oil in the world market in recent years. Cooperation among major producer countries in various commodities could be a useful and effective route to take to improve the terms of trade of commodity-exporting developing countries.

Proposals

(a) It should be recognized, including by the Financing for Development process, that the decline in commodity prices and in the terms of trade constitutes a major (and perhaps even the single most important) factor hindering most developing countries from obtaining adequate financial resources for savings and investment. It is imperative that such huge income losses incurred by poor countries be stemmed and, if possible, reversed. With this recognition of the seriousness of the problem should come a commitment to measures for international cooperation that would help resolve this problem.

(b) Stabilization of commodity prices at reasonable levels should be the topic of an international conference or convention aimed at creating institutional mechanisms to deal with the issue.

(c) Countries could reconsider their attitude towards commodity agreements or other methods of cooperation between producers and consumers since leaving commodity trade to the full force of highly concentrated markets has resulted in negative social and environmental effects. One possibility is to initiate a new round of commodity agreements aimed at rationalizing the supply of raw materials (to take into account the need to reduce depletion of non-renewable natural resources) while ensuring fair and sufficiently high prices (to reflect ecological and social values of the resources).

(d) In the absence of joint producer-consumer attempts to improve the commodity situation, producers of export commodities could take their own initiative to rationalize their global supply so as to better match the profile of global demand. The recent sharp increase in the price of oil as a result of better coordination among producing countries is a good reminder of the benefits that producers can derive from greater cooperation.

(e) The relevant international agencies, including UNCTAD, should monitor and analyze the implications of biotechnology for developing-country commodities. Measures should be taken if impact assessments show significant negative effects on incomes and livelihoods in the South. Signatory members of the Biosafety Protocol under the Convention on Biological Diversity should exercise the protocol's mandate to consider the social implications of developments in biotechnology, especially on developing countries.

(f) There should be improvement in data collection and in analytical studies on the terms of trade of commodity exporters and of developing countries as a whole. The United Nations Secretariat and UNCTAD should publish regular reports containing historical and current data on terms of trade and on income gains or losses associated with it. The UN should also regularly analyze the implications and provide proposals on dealing with the problems.

Asymmetries in the Effect of Trade Rules on Industrial and Developing Countries

General

There is at present considerable rethinking on the nature of the multilateral trading system as embodied in the WTO. This rethinking is being carried out by developing country members of the WTO, many of which have become disillusioned by various aspects of the system. Meanwhile, there is also a high and growing level of criticism from public interest groups worldwide, culminating in street protests at Seattle (in conjunction with the WTO's Third Ministerial Conference in 1999) and other cities.

There is now widespread acceptance that the rules and processes at the WTO are imbalanced and that much needs to be done to improve the situation. Perhaps the most important decision to be taken is whether the next few years will see the WTO members doing their best to rectify the problems and imbalances in the rules and system, or whether the proposal for a "new comprehensive round" of multilateral trade negotiations will be accepted, in which case more new issues will be added to the WTO ambit that are likely to distort the trading system and add to the existing imbalances.

More than six years after the WTO's establishment, it is time for an assessment of the outcome of the Uruguay Round (which resulted in the creation of the WTO) and for a review of the future shape of the trade system. Among the concerns of the developing countries are the following:

- Non-realization of the expected benefits of the Uruguay Round for them.
- Problems arising from the implementation of their obligations in the various WTO agreements.
- Inadequate transparency and participation of developing countries in decision-making.
- Pressures from developed countries to introduce new issues that could lead to new agreements and extra obligations on developing countries as well as to more imbalances in the system.

Non-realization of Expected Benefits to Developing Countries

The old General Agreement on Tariffs and Trade (GATT) system dealt with trade in goods. There were imbalances even in the system, as sectors of export interest to developing countries remained highly protected, particularly agriculture and textiles. In fact, developing countries had agreed to subsidize the developed countries, which had asked for time to adjust.

The main benefit the developing countries' expected from the Uruguay Round was that these two sectors would at last be opened to their products. However, both agriculture and textiles were still closed six years after the Round ended.

In agriculture, tariffs on many agriculture items of interest to developing countries are prohibitively high (some are over 200 or 300%). Domestic subsidies in the industrialized countries of the Organization for Economic Cooperation and Development (OECD) rose from US\$275 billion (annual average for base period 1986-88) to US\$326 billion in 1999 (according to OECD data), instead of declining as expected because the increase in permitted subsidies more than offset the decrease in subsidy categories that are under discipline in the WTO Agriculture Agreement.

In textiles, only a few of the items that the developing countries export have been taken off the quota list, even though more than half the implementation period (for the phase-out of the restrictions) has passed. According to the International Textiles and Clothing Bureau in June 2000, only a few quota restrictions (13 out of 750 by the US; 14 out of 219 by the EU; 29 out of 295 by Canada) had been eliminated; this raises doubts as to whether all or most of the quotas will really be removed by 2005 as mandated under the WTO Agreement on Textiles and Clothing.

There is thus an important asymmetry here: the developed countries have not lived up to their liberalization commitments, yet there is an assumption pressed upon the developing countries to liberalize their imports and investments as fast as possible. Developing countries are asked to bear the pain of rapid adjustment for a short time and told that it will surely be good for them after a few years. However, the developed countries, which advocated this policy themselves, ask for more time to adjust in the agriculture and textile sectors that have been protected for so many decades.

Besides the protection in agriculture and textiles, developed countries also have tariff peaks and tariff escalation in other products which are of export interest to developing countries. Developing countries have also been concerned about the non-tariff barriers in the developed countries that have hampered their exports. These include the use of anti-dumping measures and countervailing duties on the products of developing countries.

The tariff and non-tariff barriers in the North are costly to the developing countries in terms of lost potential exports. The value of the lost export opportunities is very high. According to an UNCTAD report,

[d]eveloping countries have been striving hard, often at considerable cost, to integrate more closely into the world economy. But protectionism in the developed countries has prevented them from fully exploiting their existing or potential competitive advantage. In low-technology industries alone, developing countries are missing out on an additional US\$700 billion in annual export earnings as a result of trade barriers. This represents at least four times the average annual private foreign capital inflows in the 1990s (including FDI). (UNCTAD, 1999b.)

Problems Faced by Developing Countries in Implementing Their Obligations

Implementing their obligations under the WTO agreements has brought many problems for developing countries. The following are some of the asymmetries, or imbalances, and problems they have faced.

- The prohibition of investment measures (such as local-content policy) and many types of subsidies (under the TRIMs and subsidies agreements) have made it harder for developing countries to adopt measures to encourage domestic industry.
- The Agriculture Agreement enables the developed countries to maintain high protection while also continuing with large subsidies. This enables them to export agriculture products at artificially cheap prices. However, many developing countries have low tariffs (in many cases they were reduced under structural adjustment programs) and low or no domestic subsidies, and are not allowed to increase their tariffs (beyond a certain rate) or increase their subsidies. There is thus a basic imbalance in the Agriculture Agreement. Many developing countries are facing problems from having liberalized their agricultural imports, as cheaper imports threaten

the viability and livelihoods of their small farmers. A recent Food and Agriculture Organization (FAO) study of the experience of 16 developing countries in implementing the Agriculture Agreement concluded that

[a] common reported concern was with a general trend towards the concentration of farms. In the virtual absence of safety nets, the process also marginalized small producers and added to unemployment and poverty. Similarly, most studies pointed to continued problems of adjustment. As an example, the rice and sugar sectors in Senegal were facing difficulties in coping with import competition despite the substantive devaluation in 1994 (FAO, 2000; FAO, 2001).

- An ideal regime of intellectual property rights (IPRs) would strike an appropriate balance between the interests of owners and users of technology, and between the IPR holder and the consumer. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) has heavily tilted the balance in favor of the IPR holder, causing difficulties for technology users and consumers. The effects of a high-standard IPR regime in developing countries have included: high and often exorbitant prices of medicines, which have reduced consumer access to affordable medicines; high pricing (due to monopolies created by IPRs) of other consumer items, including computer software; the patenting by corporations in the North of biological materials originating in the South (often referred to as “bio-piracy”); and higher costs for and lower access to industrial technology by developing countries (Khor, 2001b).
- The services agreement has many asymmetries. Service enterprises in developed countries have far greater capacity to export and to invest abroad. By comparison, developing countries’ services firms generally lack the capacity to operate in developed countries. Thus, there is an unequal outcome in benefits. The right of capital to move across frontiers (which is favorable to developed countries as the main providers of capital) is given far more weight than the movement of natural persons (where developing countries have an advantage). The agreement also puts pressure on developing countries to liberalize various services sectors, which could lead to smaller local services enterprises in developing countries losing their market share or even becoming unviable. At the same time, developing countries’ service providers are generally unable to penetrate the markets of developed countries.

These problems raise the serious issue of whether developing countries can at present, or in the future, pursue their development strategies, or meet their development needs. (These strategies and needs include industrialization, technology upgrading and development of local industries; food security and maintenance of local farms and agriculture; survival of local service providers; and fulfillment of health care and medical needs).

These problems arise from the structural imbalances and weaknesses of the WTO agreements. There is now an urgent need to redress the imbalances and problems. Surely the WTO was not created with the intention of hurting the majority of its members, or depriving them of development.

The developing countries described their implementation problems and made proposals for redressing these problems in the WTO. A summary of their proposals is in paragraphs 21 and 22 of the pre-Seattle draft Ministerial Text of October 19, 1999 (WTO, 1999). These requests have been repeated many times in the WTO General Council special sessions on implementation and in various committees and councils. Unfortunately, the developed countries have not responded positively so far. Their attitude seems to be that the developing countries entered into legally binding commitments and must abide by them however painful; any changes would require new concessions on their part. This attitude does not augur well for the WTO, for it implies that the state of imbalance will probably remain, and if developing countries “pay twice” or “three or four times,” the imbalances will become worse, and the burden more intolerable.

Proposals

(a) The developed countries should commit to meaningfully opening their markets to developing countries in sectors, products and services in which the latter are able to benefit. These would include textiles, agriculture, and products processed from raw materials, as well as labor services. A meaningful expansion of market access for developing countries would be able to provide large opportunities for earning more revenues that could be the basis for significant extra financing for development.

(b) The ongoing process in the WTO of reviewing the implementation problems arising from the existing agreements should result in appropriate changes to the rules, or authoritative interpretations by the General

Council or Ministerial Conference, that would help resolve the imbalances and the problems facing developing countries. Among the changes should be the following:

- Developing countries should be given adequate flexibility in implementing their obligations in the Agriculture Agreement on the grounds of the need for food security, defense of rural livelihoods and poverty alleviation. In developing countries, food produced for domestic consumption and the products of small farmers should be exempted from the Agriculture Agreement's rules on import liberalization and domestic subsidies.
 - In the Agreement on Trade-Related Investment Measures (TRIMs), "investment measures," such as the local-content requirement (which obliges firms to use at least a specified minimal amount of local inputs) and foreign exchange balancing (which limits imports of inputs by firms to a certain percentage of their exports), have been prohibited for most developing countries since January 2000. Such measures had been introduced to protect the country's balance of payments, promote local firms and enable more linkages to the local economy. The prohibition of these investment measures is making the attainment of development goals much more difficult and causing developing countries to lose some important policy options in the pursuit of their industrialization. The TRIMs Agreement should be amended to provide developing countries with the flexibility to continue using such investment measures to meet their development goals.
 - The TRIPS Agreement should be amended to take into account development, social and environmental concerns. For example, it should be clarified that nothing in the Agreement prevents members from taking measures (such as compulsory licensing and parallel importation) required for public health objectives; that members be allowed to prohibit the patenting of life forms; and to protect the traditional knowledge and practices of farmers, indigenous people and local communities. Meanwhile, the grace period prior to implementation should be extended until a review of TRIPS and the necessary revisions have been completed.
- (c) There should be a re-orientation in the operational principles and rules of the WTO so that the development principle is accorded the

highest priority. The principle of special and differential treatment for developing countries should be strengthened within all existing agreements and made operational and binding. Measures and policies required by developing countries for development objectives should be permitted, even if in conventional terms these are viewed as “trade-distortive.” Developing countries should be given more flexibility in the scope, depth and timing of liberalization.

(d) The next phase of the WTO’s activities should focus on the above three areas, so that the review of existing rules, the realizing of opportunities in the developed countries’ markets, and the re-orientation of the WTO to developing countries’ needs and interests, can be carried out. These processes would in themselves be a massive task, requiring the commitment, energy and resources of all WTO members. However, this effort is needed to build a mutually beneficial multilateral trading system.

The Proposed “New Issues” in the WTO: Implications for Developing countries

Analysis

While developing countries have been trying to focus the attention of the general WTO membership on an urgently needed process for resolving implementation problems, the developed countries have moved to advocating the broadening of the WTO’s mandate to incorporate new areas, including investment rules, competition policy and government procurement. Labor and environment standards were also discussed as possible subjects for the WTO.

A major reason for the failure at Seattle was the reluctance of many developing countries to give the WTO a mandate for taking on new issues or negotiating new agreements. In the preparatory process towards the Fourth Ministerial Conference in Doha, and at the Doha conference itself, a split developed among WTO members on whether to take new issues on board as subjects for negotiations towards new agreements.

Most developing countries believe the WTO should focus in the next few years on reviewing the problems connected to implementing the existing agreements and on making the necessary changes in these

agreements. These enormous tasks cannot be properly carried out if a proliferation of new issues is introduced in the next round of negotiations. The extremely limited human, technical and financial resources of developing countries and their diplomats and policy-makers would be diverted from the review process to defending their interests in the negotiations on new issues. The limited time of the WTO meeting would also be devoted mainly to the new issues.

Moreover, most of the proposed new issues would also have very serious consequences for the South's future development. Issues such as investment rules, competition policy and government procurement are not strictly trade issues, and it has been argued that they do not belong in the WTO. Some developing countries suspect that the developed countries are seeking to place these issues on the agenda to take advantage of the enforcement capability (the dispute settlement system) of the WTO, so that the developing countries can be forced to open their economies to the goods, services and companies of the developed countries. In regard to labor and environment standards, most developing countries have argued that these issues should also not be regulated by the WTO as they could be used as protectionist measures against the products and services of developing countries.

It has been argued that the developing countries should accept these "new issues" as subjects for negotiation in exchange for having their problems in connection with implementation considered by the developed countries. The developing countries have been told that their requests on implementation problems and for getting greater access in the North for their agricultural products and textiles would be considered in the context of a "comprehensive new round," meaning that they would have to accept having new issues regulated by the WTO. Agreements and obligations, however, in these new areas, would be very detrimental to developing countries, which would find even more of their development options closed; and at the same time (given the poor record of the developed countries of the North in keeping their commitments) there is no guarantee that the implementation problems would be resolved, or that products from the South, especially from the agriculture and textile sectors, would really acquire more meaningful access to northern markets.

The proposals for admitting new issues (investment, competition, procurement) through a new round are inappropriate for the following reasons: (a) Introducing new issues would distract from the other work of the WTO dealing with trade and other existing issues, as discussed above. Developing countries do not have the manpower or financial resources to cope with negotiations on new issues and the other items on the agenda.

(b) The new issues are not trade issues and should not be regulated by the WTO. If these issues are to be discussed internationally, then other, more appropriate venues should be found for them. If they are brought into the WTO, they will lead to a distortion of the multilateral trade system to the detriment of world trade. Therefore, developed countries should not seek to introduce these issues for their own interests (i.e., to get advantages over developing countries and to get these enforced through the WTO's dispute settlement mechanism). By seeking to do so, they risk destabilizing the multilateral trading system.

(c) Developing countries will be severely disadvantaged and their options for economic, social and development policies will be severely constricted, if these new issues are regulated by the WTO. The developing countries would largely be unable to take measures to boost the conditions and prospects of local firms, or to manage many aspects of their macroeconomic, financial and development policies, or government procurement policies.

(d) The WTO must stick to those trade issues, that have a legitimate place within a system of multilateral trade rules, and these rules and the system must be designed or re-designed primarily to benefit developing countries, which, after all, form the majority of the WTO membership. For Doha and future ministerial conferences, it must be very clear that no new issues can be introduced unless they meet the following criteria:

- The issue is a trade issue that is appropriate for a system of multilateral trade rules.
- The WTO is the appropriate venue, or there are no other venues that are more appropriate.
- The issue is sufficiently "mature" in that members already have an understanding of it and of how it relates to the WTO and to their interests.
- If brought into the WTO, the issue (and how it is interpreted) must clearly be in the interests of developing countries as the majority of the membership.

- There must be a consensus of all members that the issue should be introduced, and on how it should be included. This consensus must be a genuine consensus based on a full understanding by all members that are allowed to participate fully in the decision-making process in Geneva (at WTO headquarters) and at the Ministerial Conference itself. A more detailed discussion of three of the proposed new issues is provided in the Annex to this paper.

Proposals

The WTO members should focus their attention and resources in the next several years on reducing the imbalances in the existing rules and system of the WTO, resolving implementation problems of developing countries, and working towards increasing market access in the North for the South. These measures are needed to restore confidence and credibility to the WTO. Expanding the WTO's mandate before these measures are taken, would put the WTO on the wrong path for the reasons discussed above. Therefore proponents of the new issues should not proceed with their advocacy. In the event that they continue to push for introducing new issues, the developing countries should refuse these proposals and insist that the next phase of the WTO's development be focused on the processes of review, reform and re-orientation.

The WTO'S Fourth Ministerial Conference in Doha: A Brief Analysis

The Fourth Ministerial Conference of the WTO was held in Doha. Originally scheduled for five days (9-13 November 2001), the conference was extended by an extra day – to 14 November – because the work could not be concluded by the scheduled date. Several heads of developing country delegations had left the meeting before it concluded because the extension was not announced until November 13th.

The Doha Conference produced three main documents: a Ministerial Declaration (WTO 2001b); a Declaration on the TRIPS Agreement and Public Health (WTO 2001c); and a decision on Implementation-related Issues and Concerns (WTO 2001d). The Ministerial Declaration

initiated a heavy work program that placed an onerous burden on developing countries, one that they will find difficult to cope with. In addition to the already mandated negotiations and reviews, the post-Doha work program will include new negotiations on market access for non-agriculture products, negotiations on some aspects of trade and environment, negotiations to clarify some rules (including anti-dumping, subsidies and countervailing measures) and dispute settlements. Part of the work program will also be the set of "implementation issues and concerns" that developing countries had put forward earlier, and the four Singapore issues: investment, competition policy, transparency in government procurement and trade facilitation. The negotiations are to be supervised by a Trade Negotiations Committee, and concluded by January 1, 2005. The outcome of the negotiations will be treated as parts of a "single undertaking."

The most contentious aspect of the Doha Conference, and the preparatory process before it, involved the "Singapore issues." During the preparatory process, a large number of developing countries opposed the commencement of negotiations on these issues, and proposed that the "study process" on these subjects should continue instead. These views were expressed by many countries at the WTO meetings in Geneva in preparation for Doha, as well as in joint statements made by the ministers in the least developed countries and by the African countries at their own preparatory meetings. However, these positions were not reflected in the draft Ministerial Declaration (WTO 2001a) that was transmitted by the Chairman of the WTO General Council and the Director-General of the WTO Secretariat to the Doha Ministerial Conference. The draft committed the members to negotiations on all four issues. In fact, negotiations would begin immediately for transparency in government procurement and trade facilitation, and two years later, after the Fifth Ministerial Conference, for investment and competition. The draft ignored the views of both the least developed countries group and several non-LDC African countries that negotiations should not begin on industrial tariffs (or non-agriculture market access). They asked instead for a study process to be initiated to look into their concerns that previous industrial tariff cuts had resulted in de-industrialization and the closure of many local firms. The draft, however, committed the members to immediate negotiations.

Despite requests by many developing countries that the Geneva draft be amended or at least that their views be reflected in an annex or a cover letter, the Geneva draft was transmitted to Doha as the basis for the negotiations at the Conference – with neither an annex, nor a cover letter explaining the divergent views. At Doha, many developing countries again stated their opposition to a draft declaration that committed the WTO to negotiating the Singapore issues. However, once again a commitment to negotiate these issues found its way in two further drafts during the Conference.

In the final draft, which the Secretariat released on the Conference's last morning on November 14th, the ministers agreed that negotiations would take place on all four issues after the Fifth Ministerial Conference (scheduled for 2003), on the basis of a decision to be taken by explicit consensus at that session on the modalities for negotiations (WTO 2001b). In a final consultation meeting on the same afternoon, more than ten developing countries suggested that the text be changed to remove the commitment to negotiations on the four issues. India indicated it could not agree to the Declaration unless amendments were made. Eventually, a compromise was worked out. At the formal closing ceremony, the Conference Chairman, Mr. Youssef Hussain Kamal, the Minister for Finance, Economy and Trade of Qatar, read a statement to the effect that a decision would indeed have to be taken at the Fifth Ministerial Conference by explicit consensus before negotiations could proceed on the four issues. He also clarified that this would give each member the right to take a position on modalities that would prevent negotiations from proceeding until that member is prepared to join in an explicit consensus (Kamal 2001).

One of the more significant discussions that can be expected at the WTO in the wake of the Doha Conference is in regard to the status of the Singapore issues: does the Ministerial Declaration (with its commitment to negotiations after the Fifth Conference) or the Doha Conference Chairman's understanding (that a decision by consensus is needed before negotiations can proceed) take precedence? In any case, the Declaration has already mapped out a work program for the next two years on the four issues, with an agenda of specific topics that appear to be in a pre-negotiations mode. For example, in the area of investment, work will focus on scope and definition, transparency, pre-establishment commitments, exceptions, dispute settlement, and so on. Thus, there will be a serious and

very heavy work program already in regard to the Singapore issues in the period prior to the Fifth Ministerial; and if a decision is taken then to begin negotiations, the workload will increase even further. Needless to say, should the negotiations lead to the establishment of new agreements, the burden of obligations on developing countries will be much heavier, and the scope of the WTO's mandate will expand immensely.

If that happens will depend on whether the developing countries can deepen their understanding of the issues in the months ahead, whether they consider it to be in their interest to have the proposed new agreements in the WTO, and whether they can persuade the developed countries to adopt their position, or whether they can resist the latter's pressure, if they decide they do not want these issues developed into WTO treaties.

The Doha Conference and its preparatory process also raised again the issue of transparency and the limited ability of developing countries to participate in decision-making. Although the developing countries prepared themselves well and played an active role in making their views known at the WTO meetings and consultations in Geneva, their views were not reflected properly (and in some areas not at all) in the various drafts of the Ministerial Declaration that were produced in Geneva and, subsequently, at Doha. Although the contents of the last Geneva draft were heavily disputed by many developing countries, the draft was nevertheless transmitted without any changes and in a form that did not incorporate the various diverging views and options. These omissions placed the dissenting developing countries at a grave disadvantage. When a large number of developing countries were still opposed to negotiations on the Singapore issues on November 13th, the last scheduled day, the Conference was simply extended by another day. On the final night, a "Green Room" meeting involving only 24 countries was convened that lasted until 5 or 6 o'clock the next morning. The selection of the participating countries, what representative authority they had, what was discussed, who convened the meeting, and who prepared the texts and drafts (including the final Declaration text) was neither made known to the members or the public, nor decided upon by consensus.

The bias in favor of developed countries and the way developing countries were put at a disadvantage during the negotiations caused great exasperation and frustration among the delegations of many of the developing

countries, as well as among the staffs of many non-governmental organizations and social movements that witnessed the events and proceedings. Remarkably, India's Commerce and Industry Minister, Mr. Murasoli Maran, himself a major player at Doha, about his experiences at the Conference:

Apart from not seriously reflecting the views of the developing members, the draft Declaration and the manner in which it was transmitted from Geneva to the Ministerial left a lot to be desired. Even at Doha, when the process reached nowhere on 13 November, the scene shifted to the so-called 'Green Room', where only a handful of WTO members were requested to participate. The remaining members virtually had no say... The tactics seemed to be to produce a draft at the wee hours and force others to accept that or come nearer to that.... Any system which in the last minute forces many developing countries to accept texts in areas of crucial importance to them cannot be a fair system. (Maran 2001: 5-6).

Although promises have been made many times by the developed countries and by the management of the WTO Secretariat to do away with non-transparent and selective procedures such as the exclusive "Green Room meetings," and to ensure greater participation of developing country members, the unsatisfactory procedures and methods used both before and at Doha have made clear that the situation is more unsatisfactory than ever, and thus that reform in the decision-making processes and procedures of the WTO is imperative. Until such a reform is undertaken, it is unlikely that the developing countries' efforts to improve their positions and promote their interests in the WTO and in the multilateral trading system will bear fruit.

Rethinking the Scope of the WTO's Mandate and the Role of Other Agencies in the Trading System

It is misleading to equate the WTO with the "multilateral trading system," as is often done in many discussions. In fact, the WTO is both less than and more than the global trade system. There are key issues regarding world trade that the WTO is not seriously concerned with, including the trends and problems of the terms of trade of its members, and the problems in primary commodity markets (including low commodity prices). On the other hand, the WTO has become deeply involved in domestic policy issues such as intellectual property laws and domestic investment and

subsidy policies. There are also proposals to bring in other non-trade issues, including labor and environment standards.

The WTO and its predecessor, the GATT, have evolved trade principles (such as non-discrimination, most-favored-nation (MFN) treatment and national treatment) that were defined in the context of trade in goods. It is by no means certain, or agreed, that the application of the same principles to areas other than trade would lead to positive outcomes. Indeed, the incorporation of non-trade issues into the WTO system could distort the work of the WTO itself and the multilateral trading system.

Therefore, a fundamental rethinking of the mandate and scope of the WTO is required. First, issues that are not trade issues should not be introduced in the WTO as subjects for regulation. This rule should apply at least until the question of the appropriateness and criteria of proposed issues have been dealt with satisfactorily in a systemic manner.

Secondly, a review should be made of the issues that are currently in the WTO to determine whether the WTO is the appropriate venue for them. Prominent trade economists such as Jagdish Bhagwati and T.N. Srinivasan have concluded that it was a mistake to have incorporated intellectual property as an issue in the Uruguay Round and in the WTO. There should be a serious consideration, starting with the mandated review process, of transferring the TRIPS Agreement from the WTO to a more suitable forum.

Within its traditional ambit of trade in goods, the WTO should reorient its primary operational objectives and principles towards development, as elaborated in the sections above. The imbalances in the agreements related to goods should be ironed out, with the “re-balancing” designed to meet the development needs of developing countries and to be more in line with the realities of the liberalization and development processes.

With these changes, the WTO could play its role in the designing and maintenance of fair rules for trade better, and thus contribute towards a balanced, predictable international trading system that is designed to produce and promote development.

The WTO, reformed along the lines above, should then be seen as a key component of the international trading system, co-existing with, complementing and cooperating with other organizations. Together, the WTO and

these other organizations would then operate within the framework of the trading system.

Other critical trade issues should be dealt with by other organizations, which should be given the mandate, support and resources to carry out their tasks effectively. These other issues should include the following: (i) assisting developing countries to build their capacity for production, marketing, distribution and trade; (ii) monitoring and stabilizing commodity markets with a view to ensuring reasonable prices and earnings for commodity-producing developing countries; (iii) addressing the restrictive business and trade practices of transnational corporations that make it difficult for smaller firms to engage in production and trade; and (iv) addressing the problems of low commodity prices and developing countries' terms of trade. These issues can be dealt with by various UN bodies, especially a revitalized UNCTAD.

ANNEX

An Analysis of Some of the Proposed New Issues in the WTO

The following is a brief analysis of three of the proposed new issues (investment, transparency in government procurement, and competition) that are being advocated by some WTO members. This discussion is then followed by some proposals for positions developing countries could take on these issues. In the following analysis, it was recognized that the Chairman of the WTO's Fourth Ministerial Conference at Doha had stated in the concluding plenary session that there would be a need for an explicit consensus before negotiations could begin on the four "Singapore issues." This suggests that the developing countries can still take the position at the Fifth Ministerial Conference in 2003 that they do not wish to commence negotiations.

Investment

The main proponents of an investment agreement would like to have internationally binding rules that accord foreign investors the right to enter countries without conditions and regulations, to operate in host countries without most of the conditions now existing, and to be granted "national treatment" and MFN status. Performance requirements and restrictions on movements of funds would be prohibited. There would also be strict standards of protection for investors' rights in regard to "expropriation" of property. (A wide definition could be given to "expropriation"; the NAFTA experience is worth noting.)

However, since this extreme model has proven to be very unpopular, the major proponents are now offering watered-down versions, such as an approach structured along the lines of the WTO services agreement framework; a plurilateral approach; a multilateral agreement confined to transparency in the first stage; and a bridging approach (continue discussions for two years and then upgrade to negotiations for an agreement automatically after that). These step-by-step approaches are aimed at first getting members to agree to the *concept* that investment rules belong within the mandate of the WTO and then drawing them into an agreement that appears to be rel-

atively harmless and seems to offer some room to make choices. Later on, they can be pressured into liberalizing more and more in terms of sectors and the depth of policy measures.

It should be recognized that the watered-down versions represent only a shift in tactics, but not in the ultimate goals. Once an initial agreement with limited scope and commitments has been obtained, pressure will be applied to widen the scope and deepen the commitments in subsequent rounds of negotiations.

An international agreement on investment rules of this type is ultimately designed to maximize foreign investors' rights while minimizing the authority, rights and policy space of governments in developing countries. This can have serious consequences in terms of policy-making in economic, social and political spheres, by affecting the ability to plan in relation to local participation and ownership; the balancing of equity shares between foreigners and locals, and between local communities; and the ability to build the capacity of local firms and entrepreneurs. It could also weaken the bargaining position of governments *vis-à-vis* foreign investors (including portfolio investors) and creditors.

Proposed Position: The following position could be taken by developing countries when discussions resume in the WTO:

- Investment is not a trade issue. Thus, bringing it within the ambit of the WTO would be an aberration that could cause distortion to the trade system. It is certainly not clear whether the principles of the WTO (including national treatment and MFN) that apply to trade in goods should also apply to investment, and even if they do apply, that they would benefit developing countries. Traditionally, developing countries have had the freedom and right to regulate the entry and conditions of establishment and operation of foreign investments; restricting these rights could cause adverse repercussions.
- The discussions in the WTO working group on trade and investment are neither complete nor conclusive. The implications for the development of an investment agreement, of whatever type, have neither been fully discussed nor understood.
- Therefore, the WTO should not decide at the Fifth Ministerial Conference to begin negotiations on an investment agreement.

Government Procurement

The Singapore WTO Ministerial Conference (1996) agreed “to establish a working group to conduct a study on transparency in government procurement practices, taking into account national policies, and based on this study, to develop elements for inclusion in an appropriate agreement.” The decision did not specify that this must result in an agreement; it only committed members to a working group to study the subject of transparency and, based on the results of this study, to develop the elements to include in an *appropriate* agreement. It is, therefore, still possible to limit the progress towards an agreement, and to describe what agreement, if any, would be appropriate.

Although the study in the working group, and the agreement, is only mandated to cover transparency (and not the actual practices of government procurement), the major countries pushing this issue have made it clear that their ultimate goal is to fully integrate the huge, worldwide government procurement market into the WTO rules and system. At present, WTO members are allowed to exempt government procurement from WTO market access rules. The exceptions are those members that have joined the WTO’s plurilateral agreement on government procurement. Since the proposal for fully integrating procurement into the WTO is unpopular among nearly all of the developing countries, the major developed countries have devised the tactic of a two-stage process: first they aim to draw all members into an agreement on transparency; then they want to extend the scope of the agreement from transparency to other areas (for example, due process), and then to the ultimate areas of market access and MFN and national treatment for foreign firms. This is clear from various papers that have been presented by the major developed countries.

If the integration of procurement into the WTO eventually takes place (according to the aim of the major developed countries), governments in future will not be allowed to give preference to local companies to supply goods and services or to obtain concessions for projects. The effects on developing countries would be severe since government procurement has a number of very important economic, social and even political roles in developing countries:

- The level of expenditure, and the possibility to direct expenditures to locally produced materials, is a major macroeconomic instrument for countering economic downturns, especially during recessionary periods.

- National policies can give preference to local firms, suppliers and contractors in order to boost the domestic economy and the participation of locals in economic development and benefits.
- Certain groups or communities, especially those that are under-represented in economic standing, can be given special preference.
- When foreign firms are invited to bid, preference can be given to firms from particular countries (e.g., other developing countries, or particular developed countries, with which the developing country has a special commercial or political relationship).

Should government procurement be opened up through the national treatment and MFN principles, the possibility for a government to use procurement as an instrument for development would be severely curtailed. For example:

- If the foreign share increases, government attempts to boost the economy through increased spending during a downturn would result in “leakage.”
- The ability to assist local companies and particular socio-economic groups or ethnic communities would be seriously curtailed.
- The ability to give preferences to certain foreign countries would similarly be curtailed.

Proposed Position

In light of the above background information on the strategy of the major developed countries, a position should be taken that reflects the overall strategic situation, rather than a position that is only focused on technicalities or legalities.

The discussions on “transparency” and a “transparency agreement” should be seen in the light of the strategic objective of the major developed countries to draw the developing countries into accepting the real goal of market access and full integration of procurement practices. Therefore, if there is an agreement on transparency, it is likely to be the start of a slippery slope that would probably lead, in years ahead, to a full-fledged market-access agreement.

The following positions could thus be taken:

- Developing countries (DCs) have yet to fully comprehend and appreciate the desirability, degree of appropriateness and implications of a transparency agreement in the WTO, especially in regard to its effects on social, economic and political development;
- The DCs are extremely concerned that introducing the subject, even in a limited transparency aspect, would lead step by step, to market access issues. Their concerns on this matter must be allayed before they will be comfortable discussing transparency. How can these concerns can be allayed to the DCs' full satisfaction?
- The DCs are not convinced that an agreement, even if it is confined to transparency, can be properly implemented, or that its implementation will be beneficial for them.
- Since the issues are so complex, there should be no decision to begin negotiations after the WTO's Fifth Ministerial Conference. It is by no means a foregone conclusion that an agreement can be reached that every country is satisfied with.

In the continuing discussions in the working group, and in the preparatory process for Doha, positions should also be worked out in detail on the following issues: the problems of implementing a transparency agreement; the scope of a transparency agreement; the definition of "transparency"; and the question of whether transparency should be linked to the dispute settlement system in the WTO. The agreement, if any, should be in the form of non-binding guidelines rather than a legally binding document.

Competition

At the Singapore Ministerial (1996), the ministers decided to set up a working group on the interaction between trade and competition policy. There was specific mention that this would not commit members to negotiating an agreement in the WTO on competition.

The main aim of the EU (the main proponent) is to establish competition laws and policies in developing countries that would enable large foreign firms to compete in a "free competition" environment. Any advantages enjoyed by local firms (in terms of government policy or private-sector practices) are considered to be unfair competition.

The EU proposal is to have multilateral rules requiring members to establish national competition laws and policies. These laws/policies must incorporate the “core principles of the WTO,” which are defined as transparency, non-discrimination, MFN and national treatment.

Competition laws and policies, in appropriate forms, are beneficial to a country. However, each country must enjoy full flexibility in choosing a suitable model that can also be changed to suit changing conditions. Having an appropriate model is especially important in the context of globalization and liberalization, when local firms are already facing intense foreign competition.

The EU proposal for a competition policy to provide “effective opportunity for competition” in local markets for foreign firms, and thus, to apply the WTO “core principles” to competition law/policy, would affect the flexibility developing countries need in order to have their own appropriate models of competition law/policy.

Competition law/policy should complement other national objectives, e.g., industrial policy, or the need for local sectors to compete in the context of liberalization. Therefore, traditional models of competition, or those of the UK and the US, may not be appropriate for developing countries. On the other hand, the Japanese model of the 1950s-70s may be more appropriate, but would probably not be allowed under the EU’s proposed framework of applying WTO principles to competition policy.

If a multilateral approach is needed, there are other venues that are more suitable, e.g., UNCTAD, with its Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices.

Competition can be viewed from many perspectives. From the developing countries’ perspective, it is important to curb mega-mergers and acquisitions that threaten the competitive position of local firms in those countries. The abuse of anti-dumping actions in the West is also designed to limit the competitiveness of developing countries’ products. The restrictive business practices of large firms also hinder competition. However, these issues are unlikely to find favor with the major developed countries, especially the US, which wants to continue its use of anti-dumping actions as a protectionist device. If negotiations begin, the EU interpretation of competition, i.e., the need for foreign firms to have national treatment and free competition, could well prevail, especially considering the unequal negotiating strength that works against the developing countries.

The likely result is that developing countries would have to establish national competition laws and policies that are inappropriate for their conditions. These would curb the right of governments to provide advantages to local firms, and local firms themselves would be restricted from practices that are to their advantage.

These complex issues have not been adequately explored, especially the development aspects and the effects of the proposals on development.

Proposed Position: The issue of the interaction between trade and competition policy is extremely complex, since there are so many aspects, definitions and interpretations of “competition,” as well as principles of trade policy that must be considered. Moreover, it is far from clear what the implications of the proposals of the EU and other proponents would be for the development prospects of developing countries. Therefore, developing countries cannot agree at the Fifth Ministerial Conference to begin negotiations on establishing a multilateral framework or agreement on trade and competition policy. At best, the work of the study group can continue, and it should focus on the implications for developing countries of the previous and future proposals on the subject.

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Appendix I

List of Participants

INVITED SPEAKERS

Mr. Ariel Buira	St. Antony's College, Oxford University
Mr. Martin Khor	Director, Third World Network, Malaysia
Ms. Ruth de Krivoy	Chairperson, <i>Sintesis Financiera</i> , Caracas, Venezuela
Mr. Leiv Lunde	Senior Policy Analyst, ECON Center for Economic Analysis Oslo, Norway
Mr. Percy S. Mistry	Chairman, Oxford International Group
Mr. Kunibert Raffer	Department of Economics, University of Vienna
Mr. Arjun Sengupta	Professor, School of International Studies Jawaharlal Nehru University, India

INVITED PANELISTS

Mr. Yilmaz Akyuz	Director, Globalization and Development Strategies UNCTAD
Mr. Gerry Helleiner	Professor Emeritus, University of Toronto
Mr. Aziz Ali Mohammed	Advisor to the G-24 Chairman, G-24 Liaison Office

COLOMBIA

Mr. Mauricio Baquero	Second Secretary, Permanent Mission to the UN
Mr. Salomon Kalmanovitz	Member of the Board of Governors, <i>Banco de La Republica</i>

EGYPT

Mr. Hazem Fahmy	FfD Bureau, Permanent Mission to the UN
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GHANA

Mr. Kwabena Osei-Danquah	Minister Counsellor, Permanent Mission to the UN
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GUATEMALA

Mr. Alfonso Lopez-Figueroa Economy Research, *Banco de Guatemala*
H.E. Ms. Gert Rosenthal Ambassador and Permanent Representative to the UN

I.R. IRAN

H.E. Mr. Bagher Asadi Chairman of the G-77, Ambassador and Deputy Permanent Representative to the Permanent Mission to the UN
Mr. Mohammad Ali Zarie Zare Permanent Mission to the UN

MEXICO

Mr. Mauricio Escanero FfD Facilitator, Permanent Mission to the UN
Mr. Roberto Marino Manager, International Economic Affairs Bank of Mexico
H.E. Mr. Jorge Eduardo Navarrete Ambassador and Permanent Representative to the UN
Mr. Carlos Valera Paulino Second Secretary, Permanent Mission to the UN

NIGERIA

Mr. Aliyu Ahmed Special Assistant to the Permanent Secretary, Federal Ministry of Finance
Mr. Olukunle A. Bamgbose Senior Counsellor, Permanent Mission to the UN
Mr. Ernest C. Ebi Deputy Governor, Central Bank of Nigeria
H.E. Chief Arthur C.I. Mbanefo Ambassador and Permanent Representative to the UN
Dr. R.O. Mowoe G-24 Chairman of the Deputies and Permanent Secretary, Federal Ministry of Finance
Mr. Abdulkareem Olaye Assistant Director, Multilateral Institutions Department, Federal Ministry of Finance
Mr. A. P. E. Osio Minister, Permanent Mission to the UN
Mr. Godwill E. Ukpog Director, Central Bank of Nigeria

PAKISTAN

H.E. Mr. Shamshad Ahmad Ambassador and Permanent Representative to the UN
Mr. Aizaz Ahmad Chaudhry Counselor, Permanent Mission to the UN

PERU

Mr. Marco Balarezo Ambassador and Deputy Permanent Representative, Permanent Mission to the UN

PHILIPPINES

Ms. Ma Teresa S. Habitan Director, Department of Finance

ST. LUCIA

Ms. R. Sonia Leonce-Carryl Minister Counsellor, Chargé d’Affaires, Permanent Mission of St. Lucia to the UN

SUDAN

H.E. Mr. Mubarak Rahmtalla Ambassador and Deputy Permanent Representative to the UN

TRINIDAD AND TOBAGO

Ms. Roslyn Khan Cummings Counselor, Permanent Mission to the UN
Ms. Sheelagh de Osuna Permanent Secretary, Ministry of Finance

VENEZUELA

Mr. Mario Aguzzi-Duran First Secretary, Permanent Mission to the UN
Mr. Milos Alcalay Ambassador and Permanent Representative to the UN
Ms. Alicia Garcia Advisor on International Affairs, Central Bank of Venezuela

G-24

Mr. Irfan ul Haque G-24 Consultant
Mr. William Larralde Director, G-24 Liaison Office

IMF

Mr. Abayonn S. Atoloye Advisor to the Executive Director – Nigeria
Mr. Mohammed Dairi Alternate Executive Director – Morocco
Mr. Ondo Mane Damia Alternate Executive Director – Equatorial Guinea
Mr. Diwa C. Guinigundo Alternate Executive Director – Philippines

Mr. Rajapakse Jayatissa	Alternate Executive Director – Sri Lanka
Mr. Kwassivi Kpetico	Executive Director's Assistant – Togo
Ms. Alison Lewis	Executive Director's Assistant – Trinidad and Tobago
Mr. R. Munzberg	Special IMF Representative to the UN
Mr. Hernan Oyarzabal	Executive Director – Venezuela
Ms. Hooi Eng Phang	Advisor to the Executive Director – Malaysia
Ms. Anston Rambarran	Executive Director's Assistant – Trinidad and Tobago

OPEC FUND

Mr. Abdelkader Benamara	Director, Department of Information and Economic Services
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UNITED NATIONS

Mr. Barry Herman	Chief, Finance and Development Branch
Mr. Cristian Ossa	Senior Advisor, FfD Coordinating Secretariat
Mr. Oscar de Rojas	Executive Coordinator for FfD
Mr. George Talbot	Advisor to the FfD Secretariat

WORLD BANK

Mr. Zhu Guangyao	Executive Director – China
Mr. Inaamul Haque	Alternate Executive Director – Pakistan
Mr. Mohammed Haruna	Executive Director's Assistant
Mr. Jose Machillanda	Alternate Executive Director – Venezuela
Ms. Meskerem Mulatu	Advisor, FfD Coordinating Secretariat
Mr. Oscar Nunez	Advisor to Executive Director – Honduras
Mr. Bayo Oyewole	Advisor to the Executive Director – Nigeria
Mr. Enrique Rueda-Sabater	Senior Advisor, FfD Coordinating Secretariat
Mr. Ahmed Sadoudi	Executive Director – Algeria
Ms. Haneen Sayed	Advisor to Executive Director – Lebanon
Mr. Balmiki P. Singh	Executive Director – India
Mr. Shakti Sinha	Advisor to Executive Director – India
Mr. Aisake Taito	Advisor to Executive Director – East Asia and the Pacific
Ms. Alison Lewis	Executive Director's Assistant – Trinidad and Tobago

Appendix II

G-24 Workshop on Financing for Development

September 6-7, 2001

Nigeria House, 21st floor

828 2nd Avenue (corner of 44th St.),

New York, NY 10017

Program

September 6

9:00 - 9:30

Registration

9:30 - 10:30

Opening Session

- Welcoming statement Chairman Dr. R.O. Mowoe

- Briefing on the FfD process Ambassador Bagher Asadi,
G-77 Chairman
Mr. Oscar de Rojas,
Executive Coordinator, FfD

10:45 - 12:30

Resource Transfers:

Official Capital Flows

Chair: Dr. R.O. Mowoe

- Presentation of the paper Mr. Arjun Sengupta

- Discussant's comments Mr. Gerry Helleiner
- General discussion
- Chairman's summary

2:00 - 3:30

Resource Transfers:

Private Capital Flows

Chair: Ms. H. Sayed

- Presentation of the paper Mr. Percy Mistry

- Discussant's comments Mr. Aziz Ali Mohammed
- General discussion
- Chairman's summary

3:45 - 6:00

External Debt

Chair: Mr. Ernest Ebi

- Presentation of papers
- Discussants' comments
- General discussion
- Chairman's summary

Mr. Kunibert Raffer
and Ms. Ruth Krivoy
Messrs. Yilmaz Akyuz
and Percy Mistry

September 7

9:00 - 10:30

Global Economic

Governance: The Enhanced Role of the UN

Chair: Ms. Sheelagh de Osuna

- Presentation of the paper
- Discussant's comments
- General discussion
- Chairman's summary

Mr. Leiv Lunde
Mr. Arjun Sengupta

10:45 - 12:30

Global Economic

Governance : Transparency and Accountability of BWI

Chair: Ms. Sheelagh de Osuna

- Presentation of the paper
- Discussant's comments
- General discussion
- Chairman's summary

Mr. Ariel Buirá
Mr. Kunibert Raffer

2:00 - 3:30

Trade and Finance Issues

Chair: Mr. Balmiki Singh

- Presentation of the paper
- Discussant's Comments
- General discussion
- Chairman's summary

Mr. Martin Khor
Mr. Irfan ul Haque

3:45 - 5:30

Reflections on the experts' discussions

Chair: Amb. Milos Alkalay

- Panelists' comments
- General discussion
- Closing remarks

• Mr. Gerry Helleiner
• Mr. Yilmaz Akyuz
• Mr. Aziz Ali Mohammed
• Chairman, G-24 Deputies

Abbreviations and Acronyms

ADR	American Depositary Receipt
AIDS	Acquired Immunity Deficiency Syndrome
BADEA	Arab Bank for Economic Development in Africa
BIS	Bank for International Settlement
BWI	Bretton Woods Institutions
CAC	Collective Action Clause
CCL	Contingency Credit Line
CDC	Commonwealth Development Corporation
CDF	Comprehensive Development Framework
CFC	Common Fund for Commodities
DAC	Development Assistance Committee
EBRD	European Bank for Reconstruction and Development
ECON	Center for Economic Analysis in Oslo, Norway
ECOSOC	United Nations Economic and Social Council
EEC	European Economic Commission
EME	Emerging Market Economy
EMU	European Monetary Union
EU	European Union
FPI	Foreign Private Investment
FMO	Netherlands Development Finance Company
FSF	Financial Stability Forum
FTAP	Fair and Transparent Arbitration Process
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Cooperation
IFI	International Financial Institutions

ILO	International Labour Organization
IMF	International Monetary Fund
ITO	International Trade Organization
ITU	International Telecommunication Union
KfW	<i>Kreditanstalt für Wiederaufbau</i>
LDC	Least Developed Countries
MAI	Multilateral Agreement on Investments
MDB	Multilateral Development Bank
MIGA	Multilateral Investment Guarantee Agency
NAFTA	North American Foreign Trade Association
NGO	Non-governmental Organization
NPV	Net Present Value
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PCF	Private Capital Flows
PPP	Purchasing Power Parity
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Papers
SDR	Special Drawing Right
SILIC	Severely Indebted Low-Income Countries
TNGO	Transnational Non-Governmental Organization
TRIPs	Agreement on Trade-Related Aspects of Intellectual Property Rights
TRIMs	Agreement on Trade-Related Investment Measures
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Agency
UNESCO	United Nations Education, Social and Cultural Organization
WHO	World Health Organization
WIPO	World Intellectual Property Organization
WTO	World Trade Organization



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The G-24

The Intergovernmental Group of 24 on International Monetary Affairs (G-24) was established in 1971 to represent the interests of the developing countries in negotiations on international monetary matters. The G-24 comprises members from Africa, Asia, and Latin America and the Caribbean (eight members from each region). It meets twice a year, prior to the Spring and Fall meetings of the International Monetary Fund and the World Bank and the Development Committee (the Joint Ministerial Committee of the Boards of Governors of the World Bank and the IMF on the Transfer of Real Resources to Developing Countries). The plenary meetings of the G-24 are addressed by the heads of the IMF and the World Bank Group as well as by senior officials of the United Nations System.

The G-24 conducts a research program aimed at enhancing the understanding of policy-makers in developing countries of the complexities in the international monetary and financial system and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform. It set up in 1994 a technical group whose members are drawn from the official research agencies of member countries.



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