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Financing for Development: A Systemic View

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Finance for development: tenets

1. **Stable, long-term**
   - **e.g. returns to education require around 30 years to be repaid**

2. **Sufficiently low rates**

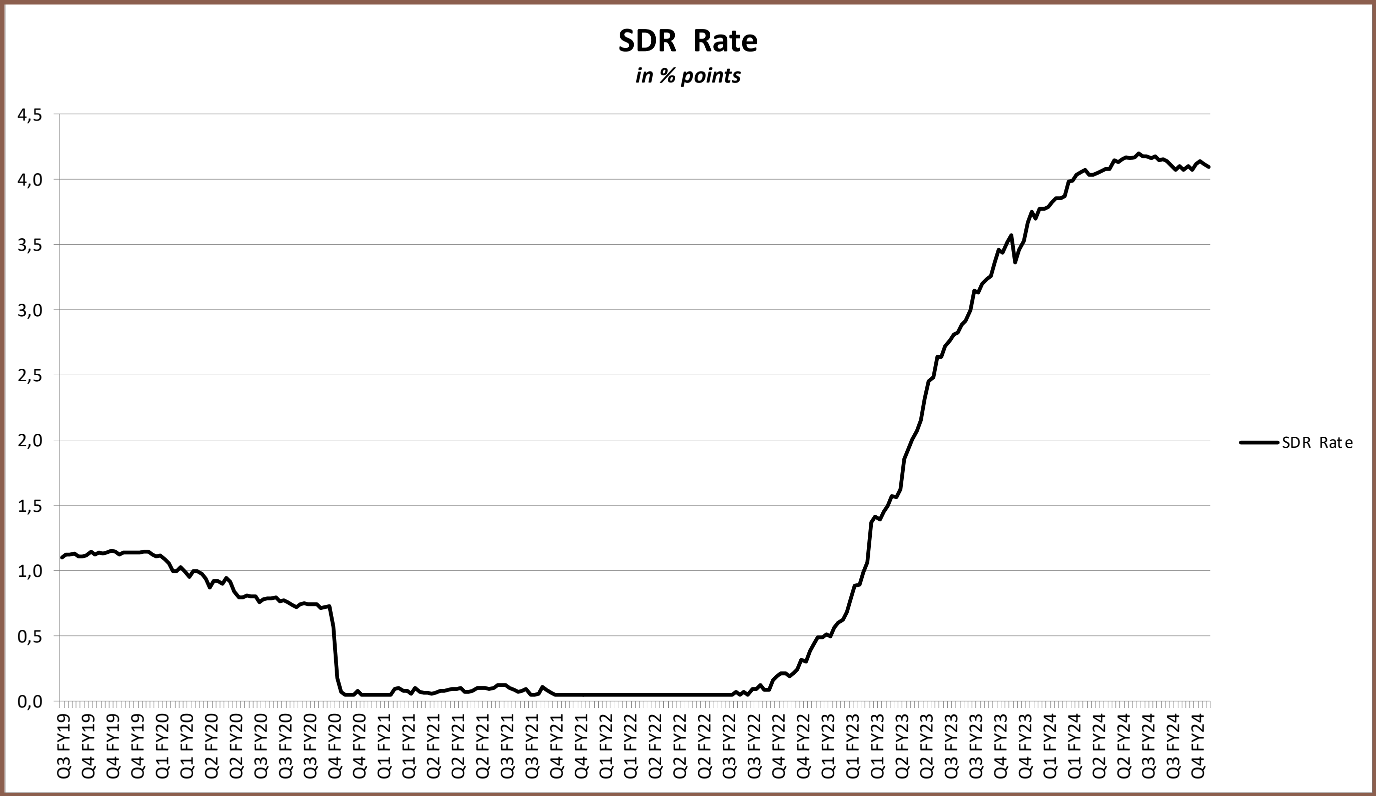
(This discussion would not take place if there were perfect capital markets.)

An asymmetric global financial system

- Private capital flows are procyclical for developing nations and countercyclical for advanced nations
  - Latin American debt crisis of the 1980s and today's debt crises in the South are examples of this asymmetry

- Official capital flows do not outweigh that asymmetry
  - Certain policies can even exarcebate it (e.g. lending cost tied to SDR rate or IMF surcharges and investment model)

The SDR rate is determined by monetary policy in AEs



Net transfers on LT External Debt to LLMICs

(Diwan-Guzman-Kessler-Songwe-Stiglitz 2024)

	Total NT TL debt	IFIs	Bilateral creditors	China loans	Private lenders
2019	84.4	28.9	1.7	4.6	54.3
2020	55.2	68.3	8.6	0.9	3.0
2021	45.4	27.3	6.4	3.5	11.0
2022	-15.7	32.2	9.8	-6.1	-51.2

Total negative net transfers (NT), with positive NT from International Financial Institutions (IFIs) and large negative NT to private creditors

The anatomy of the procyclicality of capital flows for developing nations

- Increase in global liquidity as consequence of monetary policy in advanced economies (AEs)
  - Low rates in AEs, search for yields

- Capital flows to “riskier” economies
  - Short-term and expensive

- If a shock leads to contractionary monetary policy in AEs, flows revert
  - Flight to quality

- Multiple externalities (exchange rate depreciations, etc.)
  - ”incomplete markets”: impossible to insure from those shocks

- Development falters

The anatomy of the procyclicality of capital flows for developing nations: the debtor side

- Low savings, thin capital markets

- Credit-constrained, high “shadow price” of financing

- Also: political economy considerations:
  - Discount factor for government is likely higher than for the society

- Credit/debt decisions thus mostly determined by creditors’ willingness to provide financing

- When flows revert, same structure of incentives applies
  - Leading to *too little and too late* debt restructurings and “high” short-term value for both governments and private creditors of bailouts by IFIs
  - With high short-medium term cost

Domestic currency v. foreign currency debt

- Development of local currency debt markets was generally not accompanied by adoption of capital account regulations

- Leading to the same problems of instability associated with financing in foreign currency

- The current situation: flawed approach for treatment of domestic v. foreign currency debt in recent restructurings (e.g. Sri Lanka)
  - Using same principles for the restructuring of domestic and foreign currency debt undermines the prospects for financing for development

The role of capital account regulations for the stability and cost of financing

- The case for capital account regulations in an environment of imperfect capital markets is well established

- The goal is to disincentivize carry-trade flows that create *excessive* instability of the exchange rate and of the financing conditions in domestic currency

- But to encourage more stable flows (FDI)
  - And enable the development of a domestic capital market for local savings and the management of foreign liquidity in the domestic economy

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Thank you

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