World Economic Situation and Prospects 2006

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Chapter III
Financial flows to developing and transition economies

Net transfers of financial resources

Net transfer of financial resources from developing to developed countries continues to increase

Over an extended period of nearly ten years, the international financial system has seen net transfers of financial resources from developing to developed countries. Net transfers are the net flow of financial resources less net interest and investment income payments. The magnitude of these transfers has risen steadily from an estimated $8.1 billion in 1997 to $483.4 billion in 2005 (see table III.1). The net transfer of resources from economies in transition has also followed a similar pattern since 1999, reaching an estimated $95.5 billion in 2005.

The most important destination of the net outward transfer of financial resources from developing countries taken as a whole has been to the United States of America, and has more than offset the net outward transfer from other major developed countries, namely the European Union (EU) countries and Japan, to developing countries.

Table III.1.
Net transfer of financial resources to developing economies and economies in transition, 1995-2005

Billions of dollars	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005[a]
Developing economies	38.9	16.2	-8.1	-40.7	-129.3	-192.4	-163.6	-215.6	-302.1	-374.0	-483.4
Africa	6.4	-5.7	-4.7	15.6	4.5	-26.5	-16.0	-4.9	-19.6	-32.4	-55.6
of which:											
Sub-Saharan (excluding Nigeria and South Africa)	7.4	5.3	7.5	12.1	9.3	2.8	6.8	6.1	7.0	5.3	2.0
Eastern and Southern Asia	22.1	18.5	-31.1	-128.3	-142.2	-124.3	-118.3	-149.1	-173.0	-184.8	-189.1
Western Asia	13.9	3.9	4.9	28.1	-0.9	-39.5	-32.6	-27.8	-47.6	-75.6	-154.6
Latin America	-3.5	-0.5	22.8	43.9	9.4	-2.0	3.3	-33.7	-61.8	-81.1	-84.1
Economies in transition	-2.3	-6.2	2.7	3.5	-23.6	-47.8	-29.3	-26.6	-34.5	-57.5	-95.5
Memorandum item:											
Heavily indebted poor countries (HIPCs)	6.4	7.0	7.5	8.6	10.0	8.8	8.7	9.8	10.0	10.6	12.3
Least developed countries	12.9	11.3	10.4	13.3	12.6	6.4	9.7	8.3	9.1	6.1	5.2

Sources: UN/DESA, based on International Monetary Fund (IMF), World Economic Outlook Database, September 2005, and IMF, *Balance of Payments Statistics*.
a Preliminary estimates.

As discussed in chapter I, the counterpart of the net outward transfer of financial resources from developing countries and transition economies is reflected in the growing net export surpluses of an increasing number of developing countries, caused by rapidly rising export volumes and higher prices for oil and non-oil commodities. The major increases in net export surpluses in 2005 continued to be in Western Asia, while the surpluses in East and South-East Asia and Latin America increased at a slower pace. Net transfers to sub-Saharan Africa (excluding Nigeria and South Africa) are still positive but have declined to a meagre $2 billion in 2005.

Net private capital flows: sustained positive investor sentiment and ample liquidity

Developing countries have experienced declining portfolio investment and rising FDI

Net private capital inflows to developing countries as a group fell substantially in 2005 to $95 billion from a peak of $184 billion reported in 2004 (see table III.2). Most of the decline was due to falling inflows into East, South and Western Asia, while inflows increased for Africa and Latin America and the Caribbean. There were substantial declines in portfolio investments and other investments. In contrast, foreign direct investment (FDI) flows continued to increase and remained the largest type of net capital flow to developing countries. At the same time, improved economic performance eased access to private capital markets and allowed many countries to reduce their indebtedness to official creditors. Net official flows were negative in all regions except East and South-East Asia and for countries with economies in transition.

There is strong demand for emerging market financial instruments

Sustained favourable conditions in international financial markets and strong global economic growth also continued to facilitate the access of developing and transition economies to international financing. Demand for emerging market financial instruments was boosted by the increased willingness of investors to take risks in the markets for those instruments; their search for high-yield investments was in response to continued low long-term international interest rates as well as increased international liquidity. At the same time, risk in emerging market investments was diminished by declining default risk buoyed by the continued economic growth and continued improvement in domestic and external account balances that enabled substantial reserve accumulation and repayment of debt, lowering the debt ratios of many emerging market countries. In addition, active debt management operations in a number of countries, in particular in Latin America and the Russian Federation, improved debt profiles by lengthening average debt maturities as well as by reducing the share of external and foreign currency-indexed debt. The result was an increased number of upgraded credit ratings for emerging market issuers, some to investment grade. Improved credit ratings produced a further broadening of the investor base of emerging market issuers to include global investment funds, institutional investors and hedge funds.

Yield spreads on emerging market bonds continue to decline

This positive investor sentiment was reflected in low yield spreads on global emerging market bonds in 2005 (see figure III.1). Strong financial conditions in emerging markets allowed low yield spreads to persist despite the volatility in the high-yield corporate bond markets in developed countries in early 2005 and to continue to decline through the end of the year. The surge of debt issuance by developing countries and the continued increase in international financial imbalances, however, have led to growing concerns that the low yield spreads of late 2005 may not adequately reflect the risks in emerging market bond markets.

Table III.2.
Net financial flows to developing countries and economies in transition, 1993-2005

Billions of dollars	Average annual flow				
	1993-1997	1998-2002	2003	2004	2005[a]
Developing countries (including economies in transition)					
Net private capital flows	148.4	48.2	104.6	184.0	95.4
Net direct investment	87.5	137.8	134.4	153.7	172.1
Net portfolio investment[b]	65.4	-7.2	-7.3	39.6	-28.2
Other net investment[c]	-4.5	-82.3	-22.4	-9.4	-48.5
Net official flows	12.6	7.8	-55.1	-76.5	-130.1
Total net flows	161.0	56.1	49.5	107.5	-34.7
Change in reserves	-79.9	-93.9	-323.2	-452.1	-423.7
Africa					
Net private capital flows	3.9	6.8	11.2	11.8	17.0
Net direct investment[b]	3.8	12.9	15.4	14.0	19.5
Net portfolio investment[c]	4.0	0.2	-0.9	5.3	3.2
Other net investment	-3.9	-6.3	-3.3	-7.4	-5.7
Net official flows	1.5	1.2	1.8	-0.6	-9.5
Total net flows	5.4	8.0	12.9	11.2	7.5
Change in reserves	-7.2	-7.3	-23.1	-40.2	-51.1
East and South Asia					
Net private capital flows	73.4	0.7	67.0	138.0	88.4
Net direct investment[b]	48.1	56.8	69.5	83.3	86.5
Net portfolio investment[c]	15.6	-11.7	0.8	21.3	-12.3
Other net investment	7.6	-53.7	-19.7	18.2	-0.4
Net official flows	4.2	-0.5	-16.5	6.1	13.4
Total net flows	77.6	0.2	50.5	144.0	101.8
Change in reserves	-44.2	-89.7	-231.5	-351.0	-313.4
Western Asia					
Net private capital flows	10.6	3.8	11.2	27.7	-21.8
Net direct investment[b]	4.5	4.1	11.6	11.4	17.0
Net portfolio investment[c]	-0.6	-2.9	0.4	16.1	-25.8
Other net investment	6.7	2.5	-0.8	0.1	-13.0
Net official flows	0.0	-5.4	-49.8	-77.7	-127.6
Total net flows	10.7	-1.7	-38.6	-50.0	-149.4
Change in reserves	-5.9	-1.2	-29.8	-36.9	-29.6

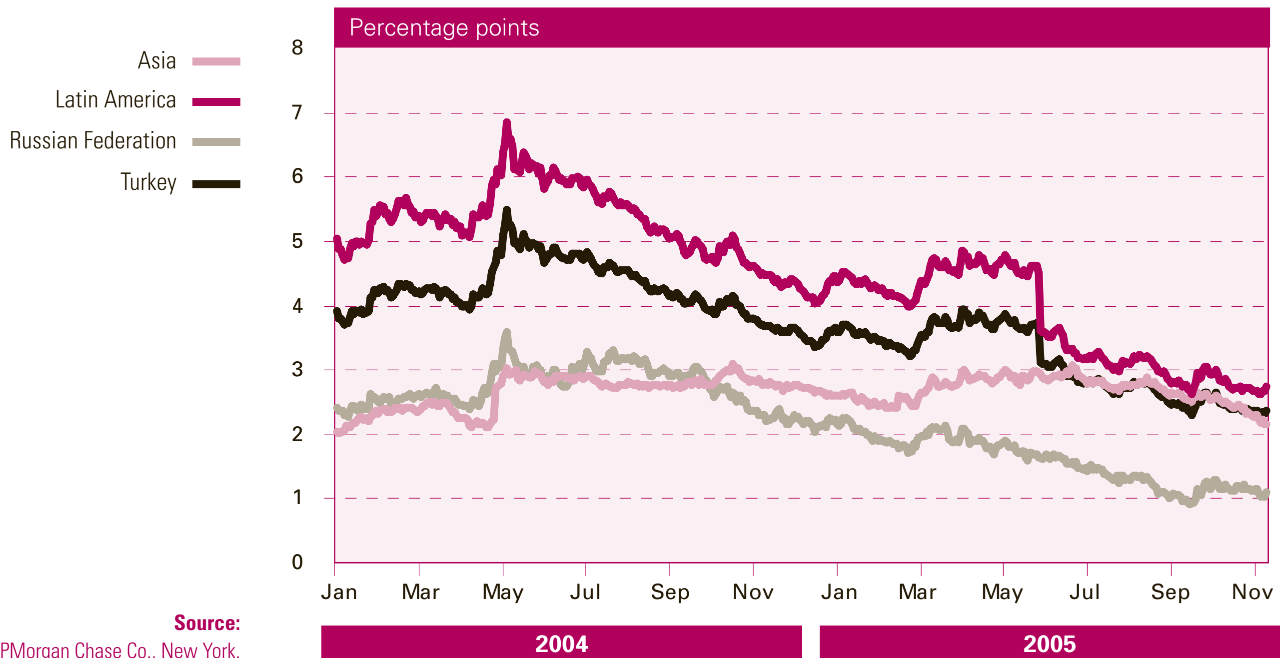
Table III.2 (continued)

	Average annual flow				
	1993-1997	1998-2002	2003	2004	2005[a]
Latin America and the Caribbean					
Net private capital flows	59.4	35.4	18.5	9.9	15.3
Net direct investment[b]	30.8	62.4	36.1	46.6	46.1
Net portfolio investment[c]	40.8	1.1	-9.0	-10.3	1.7
Other net investment	-12.1	-28.0	-8.5	-26.4	-32.5
Net official flows	2.8	12.6	7.3	-5.4	-9.0
Total net flows	62.2	48.1	25.8	4.5	6.2
Change in reserves	-19.5	5.0	-37.5	-23.7	-28.0
Economies in transition					
Net private capital flows	8.5	1.0	28.4	20.9	2.2
Net direct investment[b]	4.4	7.8	10.5	19.4	15.2
Net portfolio investment[c]	-0.2	-3.4	-3.4	4.2	-16.0
Other net investment	4.3	-3.4	21.3	-2.6	3.0
Net official flows	7.3	-0.1	-4.5	-3.5	-4.1
Total net flows	15.8	0.9	23.9	17.4	-1.9
Change in reserves	-4.8	-9.2	-37.4	-57.6	-80.8

Source: International Monetary Fund (IMF), *World Economic Outlook Database*, September 2005.

a Preliminary estimates.
b Including portfolio debt and equity investment.
c Including short- and long-term bank lending, and possibly including some official flows to data limitations.

Figure III.1.
Yield spreads on emerging market bonds, 1 January 2004-30 November 2005



Source: JPMorgan Chase Co., New York.

Under these conditions, continued monetary tightening in the United States or a slowdown in emerging market growth and export performance could result in a sharp readjustment of yield spreads and significant volatility in capital flows. Furthermore, the large holdings of emerging market securities by hedge funds could exacerbate volatility if yield spreads rise.

Under favourable financing conditions, net private capital flows in the form of investments in emerging market bonds increased substantially in 2005. Net inflows to Latin America increased, primarily to Brazil, where high domestic interest rates were combined with currency appreciation. In response to improved macroeconomic conditions, net inflows to Turkey were also strong and financed a widening current-account deficit. Net inflows to East and South-East Asia moderated, however, with declines to major borrowers such as China, the Republic of Korea and Malaysia. Promotion to investment grade of the Russian Federation, accompanied by continued rapid foreign reserve accumulation and a significantly improved debt profile, drew increased net inflows.

Governments of emerging markets issued a high volume of bonds

The high volume of net bond issuance in 2005 reflected the decisions by Governments of emerging markets to take advantage of the low financing costs, and a number of them used favourable market conditions to pre-fund 2006 and some 2007 funding requirements. The currency composition of bond issuance diversified, particularly through a substantial increase in non-dollar bonds (mostly euro) in response to strong demand from European institutional investors. Corporate bond issuance also continued to be strong, accounting for approximately half of total emerging market issuance for the year.

Conditions that supported the global emerging bond market contributed to the continued increase in foreign investment in domestic local currency bonds of emerging market countries, as well as to an incipient growth of global local currency bonds from those countries. A number of Latin American countries were able to replace sovereign foreign currency debt with local currency denominated debt, reducing the risk of currency mismatches. Prospects of monetary easing in some countries, as well as the development of local bond markets that have improved investor access and introduced new financial instruments, further boosted capital inflows to local bond markets. The creation in June 2005 of an emerging market local bond index of 19 government bond markets, an equivalent of the global emerging market bond indexes, has further facilitated the growth of foreign investment in those markets.[1] The pace of issuance of global local currency sovereign bonds by emerging market countries also accelerated in 2005, with Colombia and Brazil issuing more bonds. The size and number of these bonds, however, are still small and the investor base is narrow.

2005 saw positive net commercial bank lending to emerging markets

Net commercial bank lending to emerging markets was positive in 2005, continuing the recovery that began in 2003 after an extended decline since the late 1990s. Economies in transition accounted for a substantial part of the increase, with a strong increase in net inflows to the Russian Federation. While Latin America still registered net outflows to commercial banks in 2005, they had declined sharply from 2004. Net lending to East and South-East Asia declined, with China accounting for most of the fall owing to curbs on the overseas borrowing of banks. On the other hand, net lending to India remained substantial, owing to demand for credit from strong investment and expanding trade.

In 2005, the cost of bank credit was competitive with other sources of financing and was under almost continuous downward pressure because of abundant liquidity. Emerging market economies generally benefited from declines in spreads. In Latin America, corporations in dynamic sectors, such as oil and cement, were able to secure exceptionally low priced loans.

Net capital inflows from portfolio equity investment increased in 2005, while emerging market stock prices resumed a rising trend after a correction early in the year.

1 JPMorgan's GBI-EM (Government Bond Index—Emerging Markets).

Latin America received net inflows, mainly to Mexico and Brazil, on the strength of corporate earnings. There were also increases in net inflows to Turkey for investment in a new placement of shares issued by a State-owned company. The volume of net inflows to East and South-East Asia moderated in 2005, while investment in China and India continued to dominate inflows. Inflows to the Russian Federation strengthened as prices in the local stock market rose sharply in the latter part of the year.

Increasing foreign direct investment

FDI inflows to developing countries increased by 18 per cent in 2005

Worldwide, FDI inflows are estimated to have increased by 18 per cent to $762 billion in 2005. FDI flows increased across the board. In absolute terms, the bulk of the increase going to the EU and East and South Asia (see table III.3). FDI also increased strongly in Africa and Western Asia in relative terms, but up from low initial levels. Total FDI flows to developing countries reached $278 billion in 2005, up from $233 billion in 2004.

Two factors seem to explain much of the recent surge in FDI flows. First, corporate restructuring and buoyant profits in the major economies have pushed up share prices, while interest rates have remained low. Increased profits and favourable financing conditions have helped expand corporate investments abroad. Increasing stock market values produce positive wealth effects and facilitate takeovers, especially through stock swaps. Higher stock market valuations also boost the value of cross-border mergers and acquisitions. Most FDI takes the form of mergers and acquisitions. Second, high commodity prices have produced a recovery of FDI flows to natural resource-rich countries. The higher prices and supply

Table III.3.
Inflows of foreign direct investment, 2003-2005

Billions of dollars

Host region/country	2003	2004	2005[a]	Growth rate for 2004-2005 (percentage)
World	633	648	762	17.6
Developed economies	442	380	443	16.6
European Union	339	216	293	35.4
United States	57	96	104	8.3
Developing economies	166	233	278	19.2
Africa	18	18	30	65.8
Latin America and the Caribbean	47	68	74	9.6
Asia and Oceania	101	148	174	17.7
Western Asia	7	10	15	55.9
South, East and South-East Asia	95	138	158	15.0
South-eastern Europe and the Commonwealth of Independent States	24	35	41	16.7

Source: UNCTAD.

Note: World foreign direct investment inflows are projected on the basis of 59 economies for which data are available for part of 2005, as of 16 September 2005. Data are estimated by annualizing their available data, in most cases first-quarter data. The proportion of inflows to these economies in total inflows to their respective region or subregion in 2004 is used to extrapolate the 2005 data. Data refer to gross inflows (rather than net flows) and are based on a different reporting system, explaining the differences with the figures presented in table III.2.

a Preliminary estimates.

shortages have induced transnational corporations (TNCs) to invest in new exploration and production facilities, especially in Africa, Latin America, the Russian Federation and Central and Western Asia. Lifting constraints on foreign participation in the mining and oil sectors, particularly in Africa and Latin America, further contributed to the rise in FDI in natural resource sectors.

FDI for privatization in economies in transition decreased

FDI related to the privatization process in the economies in transition slowed down somewhat as this process nears completion in many countries. More noteworthy is the surge in FDI originating from developing countries, especially by Asian firms. In 2004 (the most recent year for which data is available) these outflows amounted to $83 billion, or about 12 per cent of worldwide FDI in that year. FDI outflows from developing countries mainly comprise mergers and acquisitions, including takeovers of large firms in developed countries. In Hong Kong Special Administrative Region (SAR) of China, Singapore and Taiwan Province of China, FDI outflows have become quite substantial when measured against domestic fixed capital formation (see table III.4). Brazil, China and India also record substantial FDI outflows in absolute terms, even though these represent relatively small shares of domestic investment levels.

Research and development are being internationalized

Another salient change to the FDI landscape relates to the internationalization of the research and development (R&D) activities of TNCs. In a number of cases, these activities target global markets and are being integrated into the core innovation networks of TNCs. This is a new development. R&D is an activity with very demanding skill, knowledge and support needs that were traditionally met only in developed countries with strong national innovation systems. As a result, few developing countries traditionally attracted R&D activities by TNCs.

Table III.4.
Outflows of foreign direct investment as a percentage of gross fixed capital formation in selected developing economies, 2002-2004

Economy	Shares in per cent[a]
Hong Kong SAR[b]	58.0
Singapore	26.1
Taiwan Province of China	11.0
Malaysia	7.7
Chile	6.4
Brazil	4.2
India	1.1
China	0.2
Memorandum items:	
Sweden	32.9
United Kingdom	20.0
France	15.0
United States	7.8
Japan	3.0
Greece	1.0
Germany	0.3

Source: UNCTAD, FDI/TNC database, available from http://www.unctad.org/fdistatistics.

a Annual average for 2002-2004.
b Special Administrative Region of China.

TNCs are the key players in global R&D, accounting for close to half of all R&D expenditures ($677 billion in 2004) and more than two thirds of global business R&D expenditures ($450 billion). Major businesses are shifting more of their R&D abroad. German companies set up more foreign R&D units in the 1990s than in the preceding half century; among major Swedish firms, the share of foreign R&D shot up from 22 per cent to 43 per cent between 1995 and 2003. The R&D expenditures of foreign affiliates worldwide climbed from an estimated $30 billion in 1993 to $67 billion in 2002.

R&D investment in developing countries has grown

TNCs also need to support their expanding production activities in developing countries with local R&D. More R&D is going to developing countries. More than half the world's top R&D spenders already conduct R&D activities in China, India or Singapore. Since the early 1990s, when Motorola established the first foreign-owned R&D laboratory in China, the number of foreign R&D units in China has grown to some 700. From practically nothing in the mid-1990s, South-East and East Asia now account for 30 per cent of all semiconductor design in the world. Thailand was the fourth overseas R&D centre for Toyota. ST-Microelectronics, one of the world's largest semi-conductor companies, has located some of its design work in Morocco. The number of such examples in developing countries is rising.

International financial cooperation

Official flows: IMF is a net receiver of resources from developing countries

IMF lending continued to decline

International Monetary Fund (IMF) support lending to developing countries continued to decline sharply in 2004, producing a net reflow of financial resources from developing countries to the IMF of $7.6 billion. This represents the reversal of a three-year trend begun in 2001. In 2003, the IMF was still a net provider of resources, transferring $4.6 billion to developing countries. One reason for the shift in the IMF's position from net provider to net recipient of financial flows from the developing countries in 2004 was fact that the IMF provided loans that were smaller in size, on average, to relatively fewer countries, resulting in lower levels of disbursements that were outpaced by the higher volume of repayments to the IMF. The continuation of a crisis-free financial environment meant that there was little demand for IMF financial support such as that extended to Argentina in 2003 ($12.6 billion), Brazil in 2002 ($35.4 billion), and Turkey, also in 2002 ($16.6 billion), to help support their crisis-recovery efforts. Data for the first nine months of 2005 seem to indicate that this trend has accelerated with net reflows of $11.7 billion from developing countries to the IMF. The IMF, in 2004, was also a net recipient of $2.4 billion from countries with economies in transition. Flows to the IMF from this group accelerated to $3.7 billion during the first nine months in 2005.

Argentina paid off and Brazil will pay off debt owed to the IMF

There was a sharp rise in loan commitments to developing countries to $12.5 billion in the first nine months of 2005, compared with $1.2 billion for the whole of 2004. This rise will, however, be countered by the announcements by both Brazil and Argentina[2] that they intend to repay their outstanding commitments to the Fund and by the near elimination of commitments to countries with economies in transition, owing to their access to the European Bank for Reconstruction and Development (EBRD). Argentina effectively paid off all of its debt to the IMF in January 2006.

2 The obligations of Argentina and Brazil to the Fund are around $25 billion and represent over 50 per cent of the outstanding support financing of the International Monetary Fund.

Overall, international financial institutions (IFIs), including the regional development banks and the World Bank, were also net receivers of funds from the developing countries in 2004, albeit on a reduced scale. Net reflows to the IFIs declined from $11 billion in 2003 to $7.1 billion in 2004 as loan repayments from developing countries and other related charges outpaced disbursements.

Official development assistance: more but still not enough

Development aid rose...

According to preliminary data from the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), in 2004 official development assistance (ODA) to the developing countries totalled $79.5 billion in nominal terms, an increase of 15 per cent over the $69 billion recorded in 2003. The average share of ODA to gross national income (GNI) of all DAC countries in 2004, however, rose only slightly to 0.26 per cent.[3] Even more encouraging is the prospect for ODA over the medium term, as significant progress has been made on commitments by major donors to deliver increased and more effective aid. More specifically, if DAC members make good on their publicly announced pledges to deliver more aid, according to projections of the DAC Secretariat, ODA will increase rise to about $130 billion in 2010.[4] This would be the largest increase in ODA by DAC countries since the Committee was established in 1960. It should be noted, however, that even with that increase, the average share of ODA to GNI of DAC countries in 2010 is forecast to equal 0.36 per cent, still far short of the 0.7 per cent commitment reaffirmed in the Monterrey Consensus and the 2005 World Summit Outcome and even below the 0.54 per cent ratio of ODA to GNI for all DAC countries recorded in 1967.[5]

...but not enough to help finance actions to meet the MDGs

The forecast increase in ODA to $97.2 billion for 2006 is still far short of the $150 billion which, according to some estimates, would be needed each year by developing countries to meet the Millennium Development Goals (MDGs) by 2015.[6] Moreover, the projected increases for ODA would make it one of the fastest-growing segments in the public spending of the donor countries. Current pressures on governments to keep fiscal balances in check could make delivery on these commitments a difficult challenge.

ODA to LDCs still falls short of the target

Not only is it important to increase ODA substantially to improve the chances of developing countries for meeting MDGs, but priority should be given to aid flows (particularly grants) to the poorest and least developed among them. With the adoption of the Programme of Action for the Least Developed Countries for the 1990s by the Second United Nations Conference on the Least Developed Countries in Paris in September 1990, the developed countries agreed that, within their 0.7 per cent overall ODA target, they would provide 0.15-0.20 per cent of their GNI as ODA to assist the least developed countries (LDCs). A few individual donors (Denmark, Luxembourg, the Netherlands, Norway and Sweden) have met this target, but aggregate ODA to LDCs fell to about half the target in the 1990s. Aid has recovered strongly

3 See "OECD-DAC Secretariat Simulation of DAC Members' Net ODA Volumes in 2006 and 2010, in constant 2004 US$ million", 12 September 2005, available from www.oecd.org/dac.

4 Ibid; see also Statement by Richard Manning, Chairman of the OECD Development Assistance Committee (DAC) to the Development Committee Meeting, 25 September 2005, available from www.oecd.org/dac.

5 See OECD, *Development Cooperation: Efforts and Policies of the Members of the Development Assistance Committee, 1974 Review* (Paris: OECD, 1974), table 55, p. 246.

6 The estimate for the amount of aid required to finance the MDGs comes from the UN Millennium Project.

since the Monterrey Conference. In 2003, for instance, ODA to LDCs totalled $19.6 billion, an increase of 42 per cent (in nominal terms) from the $13.8 billion recorded in 2000.

Meeting the MDGs will require increased shares of aid going to national development strategy budgets

The call by the development community to channel ODA towards financing specific expenditures to meet the MDGs has become stronger. The shares of technical assistance, emergency assistance and debt relief in total bilateral grants and grant-like assistance have increased over the 1990s.[7] Preliminary data for 2004 broadly confirm the levels reached in 2003 (see table A.25). While the share of aid due to debt relief has declined slightly, it is likely to be reversed, as the figures for 2005 will include Paris Club debt relief for Iraq and Nigeria (see below), while figures for 2006 will include the impact of the recently approved Multilateral Debt Relief Initiative (see below) on aid flows from multilateral institutions. Debt relief does not generally provide fresh money to debtor countries, emergency aid is not designed to assist long-term development and the contribution of technical assistance to closing financing gaps is hard to measure.[8] Meeting the MDGs will thus require increasing shares of aid that are administered directly through recipient-country budgets in support of national development strategies that incorporate the internationally agreed development goals, including the MDGs.

Official financial cooperation for development exhibited exceptional progress in the run-up to the 2005 World Summit. In May 2005, the EU responded to the call made by the Secretary-General in his report "In larger freedom: towards development, security and human rights for all" for all countries to achieve 0.5 per cent of their GNI in official assistance by 2009 and to set firm dates to reach the agreed aid target of 0.7 per cent. The EU agreed to set a collective target of 0.56 per cent for 2010. EU member States also agreed to achieve the 0.7 per cent target by 2015, while those that have achieved the target committed themselves to remaining above that target; member States which joined after 2002 agreed to strive to increase their share of ODA in GNI to 0.33 per cent by 2015.[9]

The United States has proposed a doubling of its ODA to sub-Saharan Africa between 2004 and 2010, to be disbursed through the Millennium Challenge Corporation (MCC). The MCC is a government corporation which was created in January 2004 to administer the Millennium Challenge Account (MCA), the United States' foreign aid programme. To date it has approved nearly $1 billion in assistance to five countries (Cape Verde, Georgia, Honduras, Madagascar and Nicaragua) and two Threshold Programme Funding Agreements totalling $34 million with Burkina Faso and Malawi.[10] The United States Congress approved, through the Foreign Operations Appropriations Bill, the allocation of $1.77 billion for the MCC for the fiscal year 2006 (an increase of 18 per cent over the amount approved for the fiscal year 2005). With that and the selection of 23 countries eligible for MCA funding in the fiscal year 2006, the MCC is positioned to disburse higher levels of ODA.[11]

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7 See *World Economic and Social Survey 2005: Financing for Development* (United Nations publication, Sales No. E.05.II.C.1), pp. 110-112.

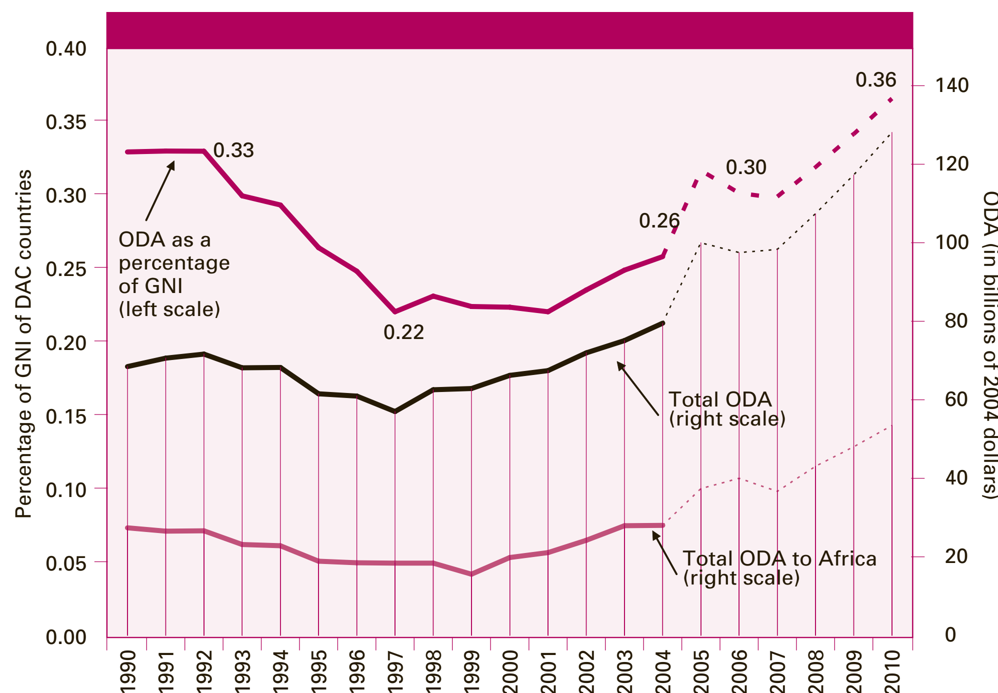
8 Statement by Richard Manning, Chairman, OECD Development Assistance Committee (DAC), to the Development Committee Spring Meeting (Washington, D.C., 17 April 2005), para.5.

9 See *World Economic and Social Survey 2005: Financing for Development.*(United Nations publication, Sales No. E.05.II.C.1), pp. 110-112.

10 The Threshold Programme is designed to assist countries committed to implementing the reforms needed to improve policy performance and eventually qualify for MCA funding. For the fiscal year 2006, 13 countries have been selected to participate in the Threshold Programme, namely: Guyana, Indonesia, Jordan, Kenya, Kyrgyztan, Malawi, the Republic of Moldova, Paraguay, the Philippines, Sao Tome and Principe, Ukraine, Uganda and Zambia.

11 The MCA-eligible countries for the fiscal year 2006 are: Armenia, Benin, Bolivia, Burkina Faso, Cape Verde, Timor-Leste, El Salvador, Gambia, Georgia, Ghana, Honduras, Lesotho, Madagascar, Mali, Mongolia, Morocco, Mozambique, Namibia, Nicaragua, Senegal, Sri Lanka, United Republic of Tanzania and Vanuatu.

Figure III.2.
Net official development assistance by DAC countries, 1990-2010[a]



Source: OECD/DAC.

a Data for 2005-2010 are projections based on commitments and pledges by DAC member states.

Initiatives to enhance aid effectiveness

In recent years there has been increasing attention to both the quantity and the quality of aid. The High-Level Forum on Aid Effectiveness, held in Paris in February-March 2005, inaugurated a system to monitor and measure progress on the delivery of pledges to enhance aid effectiveness. In preparation for the 2005 World Summit, the Working Party on Aid Effectiveness announced that it had reached a consensus on targets for the 11 indicators set out in the Paris Declaration.[12] Performance on these targets and indicators will be reviewed at the next High-Level Forum on Aid Effectiveness, to be held in Ghana in 2008.

In addition to the indicators and targets agreed by the Working Party, a follow-up to the commitments made at the 1995 World Summit for Social Development, where donors pledged to spend 20 per cent of ODA on basic social services in developing countries, would go a long way towards moving forward efforts to enhance aid effectiveness by ensuring that it is channelled through the budgets of recipient countries.

Efforts to improve aid effectiveness through institutional capacity-building continue at the regional level

Efforts to improve aid effectiveness through, among other factors, institutional capacity-building continue at the regional level. The Commission for Africa issued its report, *Our Common Interest*, evaluating progress made in Africa's objective of achieving sustainable economic growth and development.[13] On the recommendation of the Commission, and with the support of G-8 leaders at the Summit Meeting at Gleneagles, the Investment Climate Facility for Africa (ICF) was established in November 2005, designed to lower the cost of

12 The measure of progress for the twelfth indicator (untying aid) is defined as "continued progress over time". See Statement of Richard Manning, Chairman, OECD Development Assistance Committee to the Development Committee Meeting (Washington, D.C., 25 September 2005), available from www.oecd.org/dac); for the list of all 12 indicators, see also Annex in the Statement, p. 8.

13 For the full report, see www.commissionforafrica.org/english/report.

doing business in Africa and to promote a better investment climate throughout the region.[14] The ICF, a seven-year programme, is a public-private partnership funded by companies and bilateral and multilateral donors, which will work closely with African Governments and regional organizations. The United Kingdom of Great Britain and Northern Ireland is the Facility's first donor and the Royal Dutch Shell and Shell Foundation have pledged their contributions. The ICF aims to raise $120 million in its first three years of operation.

The creation of a framework for mutual accountability between Africa and its development partners is under discussion

The Economic Commission for Africa (ECA) and the OECD/DAC are engaged in a collaborative effort to create an institutional framework for mutual accountability between Africa and its development partners. The Africa Partnership Forum (APF), at its meeting in Abuja in April 2005, endorsed the creation of this framework, declared in its Communiqué that the APF is a valuable forum for enhancing mutual accountability and agreed on the need for a mutual monitoring process with clearly defined benchmarks to measure progress.[15] The participants at the meeting also agreed that the APF should provide a clear mandate to the African Union (AU), the ECA, the OECD and the New Partnership for Africa's Development (NEPAD) to provide appropriate guidelines for monitoring country performance which will serve as the basis for discussion at the next APF meeting.

South-South Cooperation is increasing

Commitment towards stronger South-South cooperation in various areas has grown

There has been growing political commitment in recent years towards stronger and wider-ranging cooperation among developing countries in trade, finance, technical cooperation and humanitarian assistance. The 2005 World Summit agreed to encourage South-South cooperation to complement North-South cooperation as an effective contribution to development.[16] Notable efforts on the part of developing countries to this end include the adoption of the Doha Plan of Action at the Second South Summit. The South Summit established the New Asian-African Strategic Partnership and other regional cooperation mechanisms and encouraged support from the international community through triangular cooperation. The Summit also created "the South Fund for Development and Humanitarian Assistance" to support economic and social development and address problems of hunger, poverty and human catastrophes in developing countries.

The major form of South-South development cooperation is technical cooperation. A recent multilateral initiative in this regard is the India-Brazil-South Africa (IBSA) Dialogue Forum. The IBSA Dialogue Forum serves as a mechanism among other things, for strengthening cooperation in specific economic and sectoral areas, and for improving economic relations between the three participating countries.[17] China has given strong support to South-South cooperation with its Technical Cooperation and Development Network, comprising 26 centres of excellence. At the 2005 World Summit it announced that it will expand its existing training and technical assistance to developing countries over the next three years.[18] India, under the India Development Initiative founded in March 2003, plans to

14 See "Blair jump-starts Africa Fund", *Business Day* (20 November 2005).

15 See "Communiqué issued at the End of the 4th Meeting of the Africa Partnership Forum held at the Nicon Hilton Hotel", Abuja, Nigeria, 9-10 April 2005", para. 10, available from www.dfid.gov.uk/pubs/files/apf/gleneagles-communique.pdf.

16 See "2005 World Summit Outcome", 20 September 2005 (A/60/L.1*), section on "Global partnership for development", pp.4-5.

17 See "Cape Town Ministerial Communiqué, India-Brazil-South Africa (IBSA) Dialogue Forum", press release, 13 March 2005, Republic of South Africa, Department of Foreign Affairs, available from www.dfa.gov.za/docs/2005/ibsa0311.htm.

18 See "Promoting universal development to achieve common prosperity", Statement by President Hu Jintao of China at the United Nations Summit (14 September 2005, New York).

provide financial and technical support to other developing countries. Brazil and Morocco underwrite scholarships to their universities and support technical and professional training for students of developing countries. Singapore offers training programmes in various disciplines, and Sri Lanka offers training in indigenously developed technology (crab breeding, uses of banana fibre, etc). Cuba has provided medical training as well as experts and support for health-care systems in and outside the Latin American and Caribbean region.

South-South cooperation in finance is flourishing

South-South cooperation in the monetary and financial areas is flourishing. The Asian financial crisis in 1997 led to the creation by the 10 members of the Association of Southeast Asian Nations (ASEAN) and China, Japan and the Republic of Korea, collectively known as "ASEAN+3" of regional institutions to harmonize financial policies and standards, regulatory systems and tax treatments. ASEAN+3 have also launched Asian Bond Funds and are currently studying the feasibility of a Pan-Asian bond index fund and a fund of bond funds.

Development cooperation among developing countries also takes the form of the provisioning of debt relief to debt-distressed developing countries. In 2000, China provided $1.27 billion (10.5 billion renminbi) in debt relief to 31 African countries. More recently, China announced that it is expanding its aid programme to the HIPC countries and LDCs. It will write off or forgive within the next two years all the overdue parts as of end-2004 of the interest-free and low-interest governmental loans owed by HIPCs that have diplomatic relations with China. Mexico and Costa Rica have also offered major debt relief to the HIPC countries in Central America. India has forgiven some $500 million in debt owed by developing countries.

Several developing countries have also been providing grant assistance. For instance, assistance flows from the financing facility of the IBSA Dialogue Forum will be in the form of non-reimbursable grants. Morocco has also provided assistance in grant form to Cotonou for the construction of a university dormitory.

HIPC Initiative and other debt-relief measures

The implementation of the HIPC initiative continues to progress slowly

Under the Heavily Indebted Poor Country (HIPC) Initiative, three countries (Honduras, Rwanda and Zambia) reached completion point in April 2005. At the end of 2005, 18 countries had reached completion point under the HIPC Initiative[19] and 10 countries had reached decision point, making them eligible to receive interim debt relief.[20] The implementation of the HIPC Initiative thus continues to progress slowly, owing mainly to the difficulty that eligible countries have in complying with the conditions required to receive full and unequivocal debt relief. To many of these countries in the interim phase of the Initiative, maintaining macroeconomic stability remains a major challenge. It is anticipated that Chad and Malawi could arrive at completion point by the first half of 2006, and the Democratic Republic of the Congo could arrive at decision point by the end of 2006. Of the countries that have reached

19 The 18 countries which have reached completion point are: Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, United Republic of Tanzania, Uganda, and Zambia. Completion point is the stage whereby the country receives the bulk of its assistance under the HIPC Initiative, without any further policy conditions. See IMF and IDA, "Heavily Indebted Poor Countries (HIPC) Initiative—status of implementation", prepared by the Staff of the IMF and the World Bank (19 August 2005).

20 The countries which have reached decision point are: Burundi, Cameroon, Chad, Democratic republic of the Congo, The Gambia, Guinea, Guinea-Bissau, Malawi, Sao Tome and Principe, and Sierra Leone.

decision point, six are moving closer to reaching completion point with the implementation of their Fund-and IDA-supported reform programmes.

Total cost to creditors of the debt relief for 28 countries is $38 billion

The total cost to creditors of the HIPC Initiative for the 28 countries in decision point and completion point is estimated to equal $38.2 billion in 2004 net present value (NPV) terms, slightly higher than the $35.7 billion estimated in 2003. The costs are about equally divided between multilateral and bilateral creditors, with the World Bank, IMF, the African Development Bank and the Inter-American Development Bank accounting for 44 per cent, and the Paris Club group of creditors accounting for 36 per cent.

Debt indicators of developing countries have improved

As a result of debt relief extended under the HIPC Initiative, most debt indicators of developing countries have improved. The debt stocks of the 18 HIPC completion point countries have fallen from $59 billion to $21 billion, or an average of 64 per cent (in NPV terms), with an additional reduction of $1 billion owing to topping up.[21] Debt-service costs for most of the 28 decision point countries are projected to be reduced sharply to less than 10 per cent of their exports. The debt service-to-exports ratio of this group fell from an average of 15.7 per cent in 1998-1999 to 7.3 per cent in 2004; as a result, debt service as a share of revenue has declined by almost half, or about $2.3 billion a year.

Countries face difficulties in reconciling objectives of debt sustainability, growth and poverty reduction

By linking the HIPC Initiative to the poverty reduction strategy (PRS) approach, more debt relief has probably led to increased poverty-reducing expenditures in the beneficiary countries. According to IMF estimates, such expenditures have risen on average by 12 per cent in 2004.[22] However, it is hard to obtain a precise estimate for the increase in pro-poor spending because of the lack of comparability of the budget accounting of such expenditures across countries. The other side of the coin is, however, that these countries continue to face difficulties in reconciling the objectives of achieving and maintaining debt sustainability, promoting long-term growth and reducing poverty. Since the implementation of poverty reduction strategies prioritizes spending in the social sectors, especially on health and education, there have been cases where some countries have had to engage in borrowing to meet deficits created by these new expenditure commitments. Sustained poverty reduction and debt sustainability also require increased domestic investment in infrastructure and in production capacity in order to raise economic growth and accelerate development.

Debt sustainability is also affected by vulnerability to external shocks. For a number of HIPCs, shocks from collapses in principal exports, droughts and other natural disasters, as well as civil unrest, have led to unsustainable debt levels. Moreover, eight of the 10 countries that have yet to reach decision point are in conflict or post-conflict situations, as well as having accumulated large protracted arrears with the international financial institutions.[23]

Other problems continue to affect, in varying degrees, the implementation of the HIPC Initiative. For instance, the number of non-Paris Club creditors that have provided or committed to deliver their share of debt relief on all claims to the HIPCs has declined. As at August 2005, eight out of the 51 non-Paris Club official bilateral donors remained fully committed themselves to delivering their share of debt relief to the HIPCs. As a result, the share of estimated HIPC Initiative debt relief that these creditors have delivered or promised to deliver had declined in 2004 from 13.6 per cent to 6.4 per cent of the estimated $3.6 billion

21 The four cases of topping-up which have been approved so far are Burkina Faso, Ethiopia, Niger and Rwanda.

22 International Monetary Fund and The World Bank, "2005 Review of the poverty reduction strategy approach: balancing accountabilities and scaling up results", prepared by the Staff of the International Monetary Fund and the World Bank, Washington, D.C. (19 August 2005).

23 This group numbered eleven as at August 2004, including Burundi which reached decision point in August 2005.

(in 2004 NPV terms).[24] Some of the reasons why non-Paris Club creditors have thus far not participated in the HIPC Initiative include a lack of understanding of the HIPC methodology and the fact that some HIPC countries have not contacted them to actively seek debt relief. Commercial creditors, which account for a small share of total debt relief under the Initiative, have not provided their share. Moreover, several commercial creditors have instituted litigation proceedings and other unilateral actions to pressure HIPCs to settle claims.[25]

The Paris Club concluded several debt-cancellation agreements

The Paris Club group of creditor countries has continued to play an active role in the HIPC process. In 2005, the Paris Club also concluded several debt-cancellation agreements, most notably with Nigeria in October. The debt-relief agreement has to be implemented in two stages after IMF approval of the Policy Support Instrument (PSI) (see below). The agreement includes the reduction of eligible debt under Naples terms and a buy-back at a market-related discount on the remaining debt after the reduction. The first phase of the agreement requires Nigeria to pay arrears due on all categories of debt and Paris Club creditors to grant a 33 per cent cancellation of eligible debts. In the second phase, and after IMF approval of the first review of the PSI, planned for March 2006, Nigeria will pay the amounts due under post-cut-off date debt, accompanied by a cancellation by Paris Club creditors of 34 per cent on eligible debt, and a buy-back by Nigeria of the remaining eligible debt. These provisions amount to a total debt cancellation of $18 billion, representing a 60 per cent reduction of the debt of Nigeria, or $30 billion, owed to the Paris Club.[26] The Paris Club also agreed on a debt-consolidation arrangement with the Dominican Republic, resulting in a significant reduction in debt service. The Paris Club also met several times during 2005 to agree to reduce debt of $124 million owed by Kyrgyzstan and to recommend to their Governments the cancellation of debts owed by Honduras, Rwanda and Zambia.[27]

Debt relief extended to post-conflict countries

The Paris Club has also actively supported post-conflict countries. In November 2004, it reached agreement on a debt reduction of $38.9 billion out of a total foreign debt of $120 billion owed by Iraq to Paris Club creditors. The arrangement featured an initial cancellation of interest arrears ($11.6 billion) in January 2005, with the balance to be deferred, pending IMF approval of its economic reform programme. Further debt reduction will reduce the debt of Iraq to the Paris Club to $7.8 billion; the rest of the debt will be payable over 23 years, with a grace period of six years. The agreement is expected to serve as a benchmark for other creditors, including Saudi Arabia and Kuwait, which hold the bulk of the debt of Iraq.

Initiative endorsed to cancel all debt owed by HIPCs to multilateral financial institutions

At the Gleneagles meeting of the G-8 in July 2005, Heads of State and Government proposed the cancellation of all debts owed by countries to the International Development Association (IDA), the IMF and the African Development Fund (AfDF) of the African Development Bank (AfDB) by HIPC countries reaching completion point.[28] The proposal was endorsed by the International Monetary and Financial Committee (IMFC) at the Annual Meeting of the World Bank and the IMF in September 2005 as the Multilateral Debt Relief Initiative (MDRI). It would cancel an estimated $55 billion in debt owed to these institutions by developing countries.

Multilateral debt relief should be additional to ODA and not impair lending capacity of multilateral institutions

The relief provided to these countries was to be in addition to official assistance available to other low-income countries and should not impair the lending capacity of the multilateral financial institutions. For IDA and AfDF these conditions were met by a G-8

24 See p. 16 of the report mentioned in footnote 22.

25 For a list of these commercial creditors, see table 3, p.19 of the report mentioned in footnote 22.

26 See Club de Paris, “Paris Club agrees on a comprehensive treatment of Nigeria’s debt”, press release, 20 October 2005, available from www.Clubdeparis.org.

27 See News at Club de Paris website, available from www.Clubdeparis.org.

28 See Chairman’s summary, Gleneagles Summit, 8 July, in Gleneagles 2005 Summit Documents, available from www.g8.gov.uk.

pledge and laid down in a letter to the President of the World Bank, stating the commitment "to cover the full cost to offset dollar for dollar the foregone principal and interest repayments of the debt cancelled for the duration of the cancelled loans".[29] Compensation from donors for costs of providing this relief will take place via an additional contribution to the current replenishment.[30] The IMF, on the other hand, will meet the costs of debt relief from its own resources. To meet a requirement, specific to the IMF, that the use of its resources be consistent with the principle of uniformity of treatment it was agreed that all countries with per capita income of $380 a year or less (HIPCs as well as non-HIPCs) would receive debt relief from IMF resources in the Poverty Reduction Growth Facility (PRGF) Trust. HIPCs with per capita income above that level will receive the Multilateral Debt Relief Initiative (MDRI) relief from existing and, if necessary, additional, bilateral contributions to the PRGF Trust.[31] A call for bilateral contributions will be issued if additional funding is necessary.

While it was agreed that there would be no new conditions applied to countries benefiting from relief, countries would be expected to maintain their existing commitments. For HIPC completion point countries, IDA relief is expected to become effective on 1 July 2006 for debts in existence at end 2003. For the IMF and the AfDF, this should occur on 1 January 2006 for debt in existence at the end of 2004, subject to approval by the bilateral contributors to the Trust.

Proposed debt relief leaves debt difficulties of non-HIPCs unresolved

While the proposal seeks to resolve known difficulties in ensuring debt sustainability for countries emerging from the HIPC process, it leaves unresolved the debt difficulties of other low and middle-income countries facing severe debt-service burdens not eligible for HIPC relief. Although initial discussions suggested that relief might be extended to non-HIPC low-income developing countries, no action was taken.[32]

In addition, the proposal only provides 100 per cent relief for debt from the three above-mentioned lenders. It provides no relief for debt to other institutional lenders such as the Inter-American Development Bank, the Caribbean Development Bank, the Asian Development Bank, or for as well as debt to bilateral official creditors who have not participated in the Paris Club, debts to commercial creditors and debts under the equal treatment clauses of the Paris Club that were incurred after the cut-off date. This means that the proposal has a differential impact across countries with similar debt burdens and in different regions.

Some regional development banks will not provide debt relief

The proposal also has implications for the approach of the participating institutional lenders to debt sustainability, since preliminary analysis suggests that countries emerging from the HIPC process and receiving full relief would have values of the relevant ratios far below the new threshold ratios proposed by the World Bank-IMF forward-looking approach to debt sustainability to allow them to qualify for grant-based aid. In the absence of providing additional grant financing for these countries, they would thus have to rely on new market borrowing to fund their MDG expenditures, creating the possibility of a new cycle of excessive borrowing and unsustainable debt.

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29 See "Letter to the President of the World Bank from the G8 Finance Ministers on the G8 Debt Proposal, Washington, 23 September 2005," in "The Multilateral Debt Relief Initiative: Implementation Modalities for IDA", International Development Association, 18 November 2005, Annex 1.1, pp. 19-21.

30 These contributions will be made on the basis of the IDA 13 burden-sharing framework. Since the G-8 only covers 90 per cent of the required additional funding, however, these shares will have to be scaled up proportionately to reach full coverage. See "The Multilateral Debt Relief Initiative: Implementation Modalities for IDA", International Development Association, 18 November 2005, p. 11.

31 See "The Multilateral Debt Relief Initiative (G-8 Proposal) and its implications for the Fund—Further considerations: Supplement on Financing arrangements", 1 November 2005.

32 Aside from IMF relief under MDRI for Cambodia and Tajikistan owing to the application of the uniformity principle noted above.

Governance of the global financial system

The International Monetary Fund has recently embarked on a reassessment of its role in the international financial system through a medium-term strategic policy review.[33] One conclusion of this review, and in line with the recommendations made in chapter I, is that international policy coordination is at its most effective when undertaken within a multilateral institution. It thus stresses the importance of safeguarding and strengthening the central role of the IMF, particularly in the area of multilateral surveillance.

The influence of the IMF in this area has been marginal because industrial countries have not required financial support since the 1970s. As a result, it has lost leverage over exchange-rate and macroeconomic policies of those countries. In addition, changes in the international financial architecture and in the Fund operations have continued to erode its original role as arbiter of the international monetary system. The inability to influence policies affecting current global imbalances, accompanied by the decision of many emerging market countries to build large foreign exchange reserves as self-insurance against crises, has further reduced the influence of the IMF.

IMF should contribute more to international policy coordination

Despite the increasing support given to low-income developing countries and to emerging market economies suffering financial crises, it is widely accepted that the Fund should remain the central institution charged with fostering global financial stability and growth. Consequently, the Fund should contribute more to international policy coordination in order to address risks to the international monetary system and global growth.

However, there is as yet no consensus on how to safeguard the central role of the IMF as the principal institution responsible for global economic and financial stability. To supplement the discussion of these issues in the medium-term strategic review, the International Monetary and Financial Committee, in September 2005, requested more specific proposals and timelines on the main tasks identified in the document. In October 2005, the G-20 Finance Ministers and Central Bank Governors also emphasized the need for more work to develop a more detailed "road map" for the future strategic reform of the Bretton Woods Institutions.

The effectiveness of IMF in this role is dependent upon an adequate voice by all members

The effectiveness and credibility of the IMF in this role as a universal and co-operative institution is dependent on adequate voice and participation by all members. After several years of extensive deliberations, the IMF and its members have, in principle, recognized the need for changes in representation and in the distribution of quotas to reflect the increased economic importance of many emerging market economies, especially in Asia, and to ensure that low-income countries are adequately represented. Political consensus has yet to be reached, however, on how to implement this general recommendation and the Spring 2006 meeting of the IMFC will only hear a progress report. In its turn, the October 2005 G-20 meeting underscored the importance of identifying principles for quota reform, which could be an important input into the IMF's Thirteenth General Review of Quotas, scheduled to be completed by January 2008.[34]

33 "The Managing Director's Report on the Fund's Medium-Term Strategy", IMF, 15 September 2005, available from www.imf.org.

34 "The G-20 Statement on Reforming the Bretton Woods Institutions", Meeting of Finance Ministers and Central Bank Governors, Xianghe, Hebei, China, 15-16 October 2005, available from www.g7.utoronto.ca/g20-051016bwi.html.

An IMF quota increase appears unnecessary

Given the assessment that the current level of the Fund resources is adequate, there appears to be no need for a quota increase. Any change in representation will then require redistribution of quotas and voting power within the existing total via an absolute reduction in quotas and voting shares of countries considered to be "overweight". Such changes are politically difficult.

Multilateral surveillance

There is a consensus that multilateral surveillance and the associated process of policy coordination and cooperation should also continue to be the core of crisis prevention efforts. In particular, with the advent of globalization, there is a need for more candid and effective surveillance over systemically important economies, with specific attention to the impact of their policies on other countries and the international economy. As noted above, improving coordination of the economic policies of the major industrialized countries is not an easy task for the IMF since those countries do not have IMF support programmes and can easily disregard its advice. As a result, some observers have suggested that the surveillance function of the IMF become fully independent of its lending and other activities. It has also been suggested that there should be increased transparency, candour and more specificity in the surveillance activities, as well as a change in the focus of multilateral surveillance from a bottom-up to a top-down approach. This new approach would involve starting with an evaluation of the needs and objectives of the international monetary system and then proceeding to the assessment of how the policies of systemically important countries can be made compatible with this evaluation.

Multilateral surveillance can only be effective if larger economies accept IMF advice

Improving the efficiency of the multilateral surveillance process, however, can only be achieved if the larger economies accept the advice of the Fund. To this end, the IMF has decided to put stronger focus on understanding and taking into account the reasons why its advice is not acted upon in specific instances.

As for bilateral country surveillance, the September 2005 IMFC meeting agreed that it should focus on areas in which the Fund can add value, such as macroeconomic and financial stability, and fiscal and debt sustainability, rather than structural policies. It should take into account particular circumstances and constraints facing individual countries in implementing policy in order to make the Fund advice more effective. An important element of this is better integration of technical assistance into the surveillance process to ensure that Governments have the expertise and capacity to implement necessary changes.

The increased size and volatility of international capital flows has been one of the most important factors affecting the Fund over the last two decades. There is now almost universal consensus that there is no need to amend the Articles of Agreement of the IMF to give the institution formal jurisdiction to deal with capital-account issues. At the same time, the strategic review emphasized the need to deepen understanding of capital movements, including the causes and potential policy implications of the pro-cyclicality of international capital flows, and to expand the analysis of the financial sector and capital markets. It is recognized that the Fund needs to ensure that its surveillance produces effective advice to individual countries on which strategies are best suited for their particular capital-account liberalization process.

International standards and codes

In 1999, the IMF and the World Bank launched an initiative to promote greater financial stability through development, dissemination, adoption and implementation of international standards and codes. As a result of its broad coverage, the initiative effort is now concentrated on updates and follow-ups according to country needs, in order to minimize their resource implications and maximize outcomes.

Preparations for implementation of the revised BIS capital adequacy requirement have been completed

The emphasis now given to international standards has produced greater interest in the arrangements for setting those standards. At their meeting in September 2005, the members of the Financial Stability Forum (FSF) encouraged standard-setting bodies to strengthen transparency and governance of their standard-setting process and to give priority to developing standards that address the most pressing risks with appropriate regard for the potential costs and benefits of implementing new standards.[35] At its 2006 meeting, the FSF will discuss work by standard-setting bodies to establish and implement best practices in their processes. The preparations for implementation of the revised Bank for International Settlements (BIS) capital adequacy requirement in the course of 2006 have also been completed (see box III.1).

The role of financial accounting and reporting standards, as well as their harmonization in safeguarding financial stability, is well understood. The process of harmonization of accounting standards began several years ago and is being coordinated by the International Accounting Standards Board (IASB). A number of international financial reporting standards (IFRS) have been finalized and have been applicable to all listed companies in the European Union since 1 January 2005. Several other countries have also adopted IFRS as their national accounting standard. It is estimated that by 2007 more than 90 countries will either permit or require the use of IFRS for publicly traded companies.[36] Common financial reporting is considered to be a major step towards improving the efficiency of international financial markets. And the momentum in the adoption of IFRS across countries is growing.

The modalities for official liquidity provision

Conditions for liquidity provision by the IMF are under discussion

In addition to the question of quota increases, the conditions for liquidity provision by the IMF to members is also under discussion. One view is that, owing to the massive support required for capital-account crises, the Fund's resources are insufficient and thus the limited nature of potential Fund financial support in response to such events should be more clearly and consistent signalled to members by enforcing regular access limits and applying the exceptional access conditions predictably and consistently. This new strategy would provide incentives for early implementation of adjustment policies in borrowing countries and for private creditors to follow the rule of prudent risk taking, thereby safeguarding the Fund's credibility. It would therefore ensure that Fund financing was combined with appropriate and timely adjustment policies in order to restore market confidence, while at the same time

35 Statement by Roger W. Ferguson, Chairman of the Financial Stability Forum, International Monetary and Financial Committee Meeting, Washington, D.C., 24 September 2005, available from www.fsforum.org.

36 Malcolm Knight, "Global banking—paradigm shift", Speech at the Fourth Conference of the Federation of Indian Chambers of Commerce and Industry, Mumbai, India, 5 October 2005, available from www.bis.org.

Box III.1

Basel II Capital Adequacy Framework

In order to eliminate anomalies in the 1988 Basel Accord on Capital Adequacy, the Basel Committee launched a proposal for revision in 1999. The revision culminated in June 2004 in what is called the Basel II Capital Adequacy framework. Guidance on two technical matters was published in July 2005 and, in November 2005, an updated version of Basel II, labelled as "International convergence of capital measurement and capital standards: A revised framework" was released.[a] Since one of the basic objectives of the Basel Capital Accords is to create uniformity of treatment of banks undertaking cross- border operations, the BIS has engaged in a series of Quantitative Impact Studies (QIS) to assess the impact of implementation of the new Accord on different types of banks operating in different countries.

The results of the fifth QIS, however, indicated substantial differences in the impact on small and large banks in developed countries. In the United States, where smaller banks have already been advised to use an adaptation of the Basel I framework,[b] the differences in effective minimum required capital for individual institutions ranged from a decrease of 47 per cent to an increase of 56 per cent. Since these difference were larger than expected and difficult to explain, the United States has decided that further study will be necessary for before proceeding to implementation[c] and full implementation is unlikely before 2011. This process will be undertaken on the basis of the fifth QIS (QIS5), which is expected to be concluded in the second quarter of 2006.

Another important area is to ensure consistency of implementation of Basel II across borders while avoiding a "one-size-fits-all" approach. The Basel Committee, through its Accord Implementation Group (AIG), is engaged in outreach efforts with supervisors in different member countries in order to promote cross-border cooperation. This cross-border work has accelerated over the past year. It has been recognized, however, that more must be done to foster greater consistency.

In many emerging economies Basel II is seen as an important catalyst for accelerating the introduction of best risk-management practices within the banking sector in the medium and longer term. According to the Financial Stability Institute (FSI), close to 90 non-member countries intend to adopt Basel II by 2010.[d] The Basel Committee itself has indicated, however, that moving rapidly to introduce the Accord is not the first priority for non-G-10 countries, which should instead first concentrate on building a strong supervisory foundation. In this regard, immediate implementation of some of the principles of Pillars 2 and 3 of the New Accord, addressing supervisory practices and expanded market discipline as preparation for the formal transition to Basel II has been suggested as a first priority.[e] A special regime, similar to that being worked out in the United States, might be more appropriate for financial institutions in developing countries.

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a See Bank for International Settlements, *Basel Committee on Banking Supervision*, available from http://www.bis.org/publ/bcbs118.htm.

b United States banking agencies have proposed a separate "Basel 1A" framework that increases the number of risk-weight categories to which credit exposures may be assigned, expands the use of external credit ratings, and employs a range of other techniques aimed at increasing the risk sensitivity of capital requirements... See NR 2005-111, United States Office of the Comptroller of the Currency, "Comptroller Dugan says Basel II capital framework will substantially enhance safety and soundness", 10 November 2005.

c See NR 2005-46, United States Office of the Comptroller of the Currency, "Acting Comptroller of the Currency Julie L. Williams testifies before House Subcommittees on Basel II framework issues", 11 May 2005.

d See Bank for International Settlements, "Implementation of the new capital adequacy framework in non-Basel Committee member countries", *Occasional Paper*, No. 4, Executive Summary, Financial Stability Institute, July 2004, available from www.bis.org/fsi.

e Jaime Caruana, "Basel II progress", 26 September 2005, available from www.bis.org.

avoiding over-lending and prolonged access to Fund resources. Financial assistance should be carefully considered in view of the overall capacity of a country to repay.

Moral hazard issues in IMF liquidity provisioning among financial crises are seen to be exaggerated

On the other hand, it is argued that, despite the rapid development and integration of international financial markets, there is still a strong rationale for the Fund to provide financing when countries face sharp declines or reversals of private capital flows. Consequently, access to liquidity during capital-account crises should be commensurate with potentially large-scale financing needs of countries that may surpass normal lending limits based on quotas of members. Large-scale financing to support economic activity, employment and trade may also be necessary owing to the fact that the catalytic effects of IMF programmes have thus far been limited. Moral hazard issues are considered to be exaggerated as empirical support is not sufficient or lacking. It has also been stressed that too much emphasis on the rules governing lending access could be counterproductive as the case of each country tends to be different, if not unique.

Another issue under discussion is the lack of harmonization of charges for different Fund facilities. This practice has opened arbitrage possibilities across different Fund instruments and has resulted in the increased attractiveness of longer-term exceptionally large borrowings, as well as "facility shopping", in which countries request support under the cheapest, but not necessarily most appropriate, facility. There is a broad agreement that this perverse incentive structure should be changed.

The use of IMF resources for crisis prevention remains an important unresolved issue

Use of Fund resources for crisis prevention remains one of the most important unresolved issues. Since the expiration of the Contingent Credit Line (CCL) in November 2003, there have been discussions on the possibility of adapting an existing instrument, such as the stand-by precautionary arrangements, to the needs of countries with strong policies facing a potential capital-account shock. Thus far, those discussions have not produced any formal recommendation because of disagreements about the feasibility of exceptional access under the precautionary arrangements as well as about the very principle of ex ante open-ended commitment of Fund resources. Meanwhile, in the absence of multilateral insurance mechanisms, emerging market countries have continued the massive build-up of reserves as a form of self-insurance. In addition, greater attention is being given to strengthening regional financial arrangements, especially in Asia. Amid these developments, the Strategic Review called for a second round of debate on the issue.

Policies on crisis resolution

There has been important progress in advancing a market-based approach to the orderly and cost-efficient resolution of financial crises. The Collective Action Clauses (CACs) in sovereign bond issues have become a market standard. The inclusion of CACs in new bond contracts, as well as in new bonds issued in sovereign debt-exchange offers, has resulted in increases in value terms of the outstanding stock of emerging market sovereign bonds that include CACs from approximately 31 per cent at the end of 2002 to approximately 53 per cent at end-June 2005.[37] Thus far, the inclusion of CACs does not appear to have had an adverse impact on the cost of issuance.

Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets agreed by four emerging market issuers—Brazil, Mexico, Turkey and the Republic of Korea—and by the Institute of International Finance (IIF) and the International Primary Market Association (IPMA), were released in November 2004 following the endorsement by

37 See IMF, "Progress report on crisis resolution", 21 September 2005, p. 3, available from www.imf.org.

the G-20. The aim of the Principles is to provide a flexible framework for communication and cooperation between debtors and creditors in order to contain crises at an early stage and resolve sovereign debt restructuring where it becomes unavoidable. The Principles are not legally binding but are meant to constitute an important complement to CACs.

Emerging market issuers and private sector creditors are now developing a process for monitoring and assessing implementation of the Principles. This work should identify circumstances where early correction could prevent crises from unfolding and offer guidance for the restructuring process in cases where debt restructuring is needed, as well as facilitate continued relevance of the Principles in light of changing market characteristics and help reveal whether the right balance has been achieved between providing sufficient guidance and allowing flexibility.[38]

There is no consensus on the role of the official sector in market-based crisis resolutions

While the market-based approach to crisis resolution and debt restructuring has received increased support in recent years, there is no consensus on the role to be played by the official sector. The debt restructuring process of Argentina has shown the need for a better framework. IMF financial support for Argentina was made difficult by the fact that an ongoing Fund programme had been suspended just before the default. Negotiations with creditors concerning sustainable debt levels could only be initiated after the Government had agreed to the economic policy conditions for continuing the existing IMF support programme. Delays in reaching agreement with the IMF were due to political instability and to the fact that the negotiations only kept existing programmes in place, rather than providing additional financial assistance. These delays meant that Argentina was to engage in negotiations with creditors over two years after the default. The extremely large size of the default, the wide geographical dispersion of creditors and the diverse nature of the credit instruments and legal regimes governing them complicated negotiations further.[39] The creation of a number of individual national and international "creditor committees" with unclear representative mandates made the bargaining process even more difficult. Finally, there was a clear divergence between the objectives of the creditors and the IMF on the one hand and the Argentine government on the other. The creditors argued in favour of the highest possible payout, while the IMF urged the government to adopt policies that maximized the fiscal surplus to provide funding for the restructuring. The Government argued that fiscal policy and the payout should be set at levels that could be sustained on a permanent basis by producing economic recovery and sustained growth of national income. The result was a divergence in the interpretation of "good faith" negotiations required for IMF lending in arrears programmes and the requirement of market support for the restructuring. In the end, a voluntary unilateral exchange offer by Argentina with an implied pay out of around 25 per cent was accepted by 75 per cent of its foreign creditors. The Government interpreted this as representing market support for the package and thus satisfying the good faith requirement. The IMF, however, continued to urge Argentina to provide conditions for the holdout creditors and a number of them continued to seek relief in court.[40] The question of the resolution of the outstanding creditors is still pending, although Argentina has clearly stated that the exchange offer will not be reopened.

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38 See, for example, the critical comments in "Observations regarding the principles for stable capital flows and fair debt restructuring in emerging markets", Ministerio de Economia y Produccion de Argentina, available from http://www.mecon.gov.ar/finanzas/download/critica_a_principles%20_final_%20exe.pdf.

39 See J. F. Hornbeck, "Argentina's sovereign debt restructuring", CRS Report for Congress (Washington, D.C., The Library of Congress, 19 October 2004).

40 The most recent filing was in mid-December 2005.

Hence, a review of the effectiveness of the instruments of the Fund to facilitate crisis resolution, including the "lending into arrears" policy and information dissemination, would help to clarify the role the Fund could be expected to play in market-based resolutions. In particular, dissemination of timely and accurate information of the debt sustainability analysis of the Fund would facilitate negotiations between the debtor and its private creditors.

IMF engagement with low-income countries

It is recognized that the IMF should not be turned into another development agency

The role of the Fund in the global development partnership has been the subject of extensive debate. It has been recognized that the IMF should not be turned into another development institution. Others, such as multilateral development banks and bilateral donors, are in a better position to provide medium- and long-term development assistance. The IMF should rather stick to its core areas of expertise, which, in the case of low-income countries, means addressing macroeconomic aspects of the development challenge, including maintaining macroeconomic stability and debt sustainability, through policy advice, capacity-building and, when necessary, financial assistance.

In this respect, one of the most important areas of work has been identified as advising low-income countries on how to deal with macroeconomic effects of higher aid flows. This includes improving public expenditures management and domestic resource mobilization, as well as increasing absorptive capacity. No less important is finding ways to deal with real exchange-rate appreciation resulting from rising aid flows.

Policy Support Instruments are established for low-income countries

In October 2005, the Executive Board of the IMF approved a proposal establishing Policy Support Instruments (PSI) for PRGF eligible members. The PSI will provide policy support and signalling to low-income countries that do not need or want financial assistance from the IMF, but still want the Fund to support their poverty reduction programmes and endorse the quality of their policies. The Instrument will be available on a voluntary basis and based on policies that meet the standard of upper credit trance conditionality. Unlike Article IV consultations, the PSI will provide an explicit endorsement of policies of low-income members.

According to the IMFC, the PSI would provide the benefits of IMF advice and policy support to countries that do not require financial support, while the PRGF would remain the main instrument for IMF financial support for low-income countries. In this regard, it has been decided to establish a new "shock window" within the PRGF for low-income countries that do not have a PRGF. This should help these countries cope with adverse short-term balance-of-payments shocks mainly in their terms of trade. Countries that are "on-track" with PSI conditions would get rapid access to the window in the event of a shock.