Report
Workshop on Debt, Finance and Emerging Issues in Financial Integration

Commonwealth Secretariat 6 and 7 March 2007

Background

The Financing for Development Office organized a Workshop on "Debt, Finance and Emerging Issues in Financial Integration"[1] in partnership with the Common Wealth Business Council and Common Wealth Secretariat in London on 6 and 7 March in accordance with the United Nations General Assembly resolution 60/188 requesting the Financing for Development Office to continue to organize workshops, multi-stakeholder consultations and panel discussions to examine issues related to the mobilization of resources for financing development and poverty eradication. The report feeds into the discussions for the High-level Dialogue on Financing for Development in 2007 and the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus to be held in Doha in the second half of 2008.

I Emerging global Issues in financial Integration[2]

Global Imbalances

Amongst the new risks in the global economy are the high current account deficits in the US economy and large current account surpluses in Asia. There is heightened concern as historically adjustments in US external deficits have had a contractionary impact on the global economy and US output. It is clear that international policy coordination is needed to avoid abrupt adjustments – the risk of a large fall of the dollar accompanied by falls in the prices of bonds and equities.

The speaker Mr. Das pointed out that the existing large global imbalances cannot be sustained forever. On the one hand, there has been massive accumulation of foreign

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[1] The participants comprised practitioners and experts from the multilateral organizations (including UN DESA, Commonwealth Secretariat, IMF, and UNCTAD) senior government representatives (including ministers and governors of central banks), the private sector, civil society and academia. Background material and presentations can be found on the events section of the Financing for Development office website: http://www.un.org/esa/ffd. A list of participants and speakers is attached.

[2] The speakers in this session were: Mr Arnab Das, Global Head of Emerging Market Strategy, Dresdner Kleinwort; Professor Charles Wyplosz, Graduate Institute of International Studies, Geneva; and, Mr David Lubin, Managing Director, Citigroup Global Markets, London. The discussants, Mr Christoph Lindemann, Economist, Deutsche Bundesbank, Frankfurt and Mr Arnab Das, Global Head of Emerging Market Strategy, Dresdner Kleinwort.

the motive for holding reserves. Looking at the ratio to GDP is justified if mercantilism is the driving motivation. Looking at trade and external liabilities is preferable if reserves are held for self-insurance. In addition, as countries become financially integrated, the smoothening them out. Existing labor market and external conditions are important in gauging the appropriateness and sustainability of current strategies. To elaborate, East Asia's policy of accumulating reserves and undervaluing the currency is not dissimilar from the measures undertaken by Germany during the post-war period, with the key difference being that the latter was a fully employed economy whereas countries such as China have surplus labor. According to Mr. Lindemann, it is not clear whether reserve accumulation is a transitory phenomenon of developing countries or a trend that will given to how the current account surpluses in the South could be systematically channeled to countries that need finance and productive investment. Indeed, from a global development perspective, it was indicated that there is a maturity mismatch of world-side savings. While there are a huge amount of funds invested in the international capital markets, financing is still not available for longer-term projects in areas such as infrastructure. Policy makers need to address this and, in the meantime, consider how to channel the large level of reserves in developing countries into productive investment (

Inevitably, the issue of crisis prevention and resolution also generated attention from participants. Countries have been accumulating reserves mainly to address sudden reversals in capital flows, including capital flight. There was a call for a greater consideration of policies and/or international financial mechanisms that could address this problem. On this point, it was noted that regional financial integration could also serve as a defense mechanism against financial crises. There was also some discussion about the effects of credit derivatives and financial engineering in general on risk management in capital markets. According to a participant, identifying the location of credit risk, say from the recycling of petrodollars, may be much more complicated as a result of these tools. It was also argued that financial engineering along with loose monetary policies might have contributed to a mis-pricing of credit risk in the financial markets.

II The Linkages between Internal and External Debt and Debt Sustainability[4]

In recent years, developing countries have been advised to build local currency bond markets. Many countries have issued domestic bonds to pay off foreign creditors, so that external debt may have down but domestic debt has increased considerably to the extent that public debt sustainability is at risk. This session examined the issues involved in building up local currency bond markets and the linkages between internal and external debt for public debt sustainability. The issue is of relevance, both for middle income and low income countries.

Local Currency Bond Markets

A key message emanating from Ms. Gopinath's presentation covering the Indian experience was that building up local currency bond markets takes times and care needs to be taken before this segment of the market is opened up to foreign investors. She also highlighted the difficulties involved in promoting corporate bonds. Local debt markets are comprised of Government securities (Central and State) and the corporate bond markets. Ms. Gopinath pointed out that India has been able to issue long-term paper in

[4] The session was moderated by Ms. Marion Williams, Governor, Central Bank of Barbados. The panel comprised Ms. Shyamala Gopinath, Deputy Governor, Reserve Bank of India; Mr. Yilmaz Akyuz, Former Director, UNCTAD; and Mr. Andres Rez, Department of Planning, Risk and Risk Management, Government Debt Management Agency, Hungary. The discussants were Mr. Edmund Fitzgerald, Professor, Department of International Development, Oxford University; and Mr. Ugo Panizza, Chief of Debt and Finance Analysis Unit, UNCTAD

the bond market; moreover most of the borrowings have been from domestic sources, and to a large degree from local banks[5]. Reforms in the early 1990s, relating to the financing of the growing fiscal deficit, and measures in later years to promote institutional development and enhance liquidity and efficiency all served to catalyze the development of the government securities market. All the borrowing is moreover in local currency. Ms. Gopinath proceeded to describe the corporate debt market in India. This has been in existence since 1947, but only after 1985 did some State-owned public enterprises (PSUs) begin issuing bonds, which were illiquid and unpopular. Financial institutions dominate public issues in the primary corporate debt market. She pointed out that corporations can borrow overseas, but this has been late to develop because they have access to bank credit and other forms of financing. Looking ahead, Ms. Gopinath stressed that it is necessary to continue the efforts to build a deep and liquid G-Sec market and recent reforms include the introduction of inflation-indexed bonds.

The linkage between internal and external debt and debt sustainability

Mr. Akyuz focused on the fiscal considerations underpinning debt sustainability in middle-income countries. He pointed out that the IMF framework for fiscal and external sustainability was developed as a result of the increasing significance of public domestic debt and private external debt in a number of developing countries. He proceeded to critique the IMF framework, which is based on the proposition that public debt cannot keep on growing relative to national income because this would require governments to constantly increase taxes and reduce spending on goods and services. However, while this describes the conditions for the debt ratio to remain stable, it does not indicate what exactly would be a sustainable debt ratio. Neither does this framework capture the dynamic interactions among the key parameters affecting fiscal and external sustainability. This is an extremely important issue since many countries need 'fiscal space' to undertake investment in infrastructure and social services. Mr. Akyuz argued the IMF looks at fiscal space as what is left after servicing debt and went on to propose a number of ways through which countries can create fiscal space, including through improving the efficiency of public spending, increasing revenue mobilization, and attracting grant aid and new borrowing. In this respect, he also underpinned the need for a viable system of debt restructuring and workouts.

Improved debt management practices to promote debt sustainability

In order to understand further the linkages between internal and external debt and the value of debt management strategies Mr. Rez adopted a balance sheet approach pointed to the usefulness of having a sovereign asset-liability management strategy as a means of managing public debt in developing countries. Such strategies have been used by banks to manage assets and risk and to undertaking hedging. While its application by governments may not be straightforward, not least because it is difficult to define sovereign assets, it could provide a useful benchmark. Mr. Rez also discussed the

[5] Though the Central government can borrow from both internal and external sources, unlike the state governments which can only borrow domestically. There is concern that encouraging greater investment from foreign investors could lead to exposure to volatile capital flows.

Hungarian case where government securities were developed in the 1990s and there was a clear separation between domestic debt and external debt during this period. However, Hungary has since successfully managed both components of debt and moreover has also handled its foreign exchange reserves well. Hungary provides a useful illustration of pro-active debt management strategy to promote debt sustainability via a balance sheet approach to debt management.

Summary of Discussion

Mr. Fitzgerald commented on the issue of the local currency bond market in India, he wanted to understand why the corporate bond market is relatively underdeveloped. This is interesting because a growing government securities market should facilitate the development of the corporate debt market through providing a benchmark yield curve. The fact that this has not happened could be because of underlying problems relating to corporate governance. It may also indicate that government securities may be absorbing savings that should otherwise be channeled to the private sector and, in particular, small and medium enterprises. On the issue of fiscal considerations underlying debt sustainability, Mr. Fitzgerald emphasized the importance of tax reform. Finally, he agreed an asset-liability approach may be a useful way of managing public debt. However, he pointed out that the issue is far more complicated at present because of increasing private borrowing and debt. The size of the currency and other liabilities of the private sector, including commercial banks, are unclear; in many instances the risk has been transferred from the public to the private sector and, according to Mr. Fitzgerald, the next series of crises could arise from company balance sheets.

Mr. Panizza pointed out that the structure and composition of debt also contributes to the level of risk, perhaps even more than the level. He added that the high volatility of spreads is another risk. Mr. Panizza also mentioned that in the real world a change in the stock of public debt does not necessarily equal the fiscal deficit due to technical measurements, hidden fiscal liabilities and changes in the composition and value of debt arising from factors such as currency devaluations.

There was discussion of capital account liberalization and its implications for debt management and bond market development. The question was raised as to how India’s experience in bond market development may have varied had there been an open capital account. In this respect, it was also pointed out that the difficulties in simultaneously managing internal and external debt have also been a function of increased activities on countries’ balance of payments capital account. In this respect, it was also pointed out that the liberalization of capital accounts makes it all the more important to address issues related to corporate balance sheet vulnerability.

III Financial Architecture – Crisis Prevention[6]

Financial crisis in a country can emanate from unsustainable debt position driven by domestic policies or be a consequence of events in international markets. The openness of the capital account can have implications for both debt sustainability and financial stability.

International Financial Architecture

According to Mr. Fried, the underlying causes of financial crises include global macroeconomic imbalances, weak financial systems, inadequate legal and accounting frameworks and information asymmetries that create uncertainty. He proceeded to outline a range of policy responses. He began by pointing out that IMF surveillance assists in crisis prevention by providing countries with assessment of risks and their weaknesses. However, it can be improved through incorporating analysis of the financial sector, capital account liberalization, Mr. Frieda argued for a gradualist stance and said that inflows should be liberalized before outflows; though the sequencing ultimately depends on a country's macroeconomic environment and its vulnerability to external shocks.

Summary of Discussion

Ms. Williams pointed out that the IMF has been more flexible on the issue of exchange rate regimes and even provided support for the fixed exchange regime adopted by Barbados. She also highlighted the fact that while more countries have floated their currencies, these have been managed floats. Nevertheless, increasing financial integration will.6(i)5,ihnn5iped i, increaiigely iffic uld for fixed exchange rate regime increaxedmove tswill

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On the issue of capital controls and regulation, it was pointed out that there has been little research on best practices with regard to capital controls. A number of participants agreed that open capital accounts are not appropriate for many developing countries today. It was stressed that China and India were sheltered from the Asian crisis, possibly because they had quite closed capital accounts, that capital controls were very effective in Malaysia and that the existence of multiple equilibria in financial markets justifies capital controls in many developing countries. While one participant argued that, as countries liberalize their capital accounts, they should only open up in areas that they are able monitor and regulate, another countered that this may not be practically possible and may render the whole process of capital account liberalization meaningless. Rather, according to the latter point of view, the key issue concerns which markets and players to regulate. More broadly, it was also pointed out that the whole issue of capital account liberalization needs to be revisited in a political economy context. For a start, it needs to be looked at not just in terms of regulating foreign investors but also as a means to prevent domestic capital flight. Moreover, the whole process may be underpinned by social factors. For example, the recent imposition of capital controls in Thailand had to be reversed most likely because it affected the interests of the politically powerful middle classes who had built up an active stake in the stock market.

Other topics discussed included standard and codes, financial instruments and lending facilities of the IMF. While the whole idea of standard and codes is to educate the financial markets, it was noted that the private sector do not take them into account when making lending and investment decisions.

III Financial Architecture (Continued) – Orderly Debt Workouts[7]

The failure of the IMF in getting stake-holders to accept its proposed Sovereign Debt Restructuring Mechanism has left a vacuum in the international debate on orderly debt workouts. This session invited views from the private sector, academia and international organizations to assess the state of present approaches to debt restructuring and recommend the way forward.

Private sectors views on orderly debt workouts

Mr. Chamberlin argued that while country debt restructuring is more likely to occur in the present environment, where there is pending legislation against a sovereign, it is nevertheless difficult to enforce legal action. In many respects, recent experiences may have favored debtors and, for example, many investors believe that Argentina's debt

[7] The session was moderated by Mr. Chukwuma Soludo, Governor, Reserve Bank of Nigeria. The presenters were Mr. Michael Chamberlin, Executive Director, Emerging Markets Trade Association;

restructuring offer was inadequate. Having said this, Mr. Chamberlin pointed out that there is a quite significant spectrum of private sector attitudes and, in the final analysis, creditor reactions to restructuring depends to a degree well as majority creditors. Overall, Mr. Herman and Ms. Spiegel concluded that for debt resolution to be timely, effective and fair, some stronger initiative is needed that uses the state and law in a different way and that facilitates the sharing of risks and responsibilities.

Summary of Discussion

Mr. Miller, pointed out that neither the IMF, nor the Paris Club, provide countries with fresh start after a default. Countries receive breathing space but not a new beginning that enables them to shake off their debt problems and embark on a sustainable growth path. There is therefore a need to focus more on the end result rather than intermediary targets and also to realize that a hasty debt write-off would be damaging for countries. He also pointed out that the SDRM had credible features, though it was dropped in favor of collective action clauses, and referred to the view of Arturo Porzekanski (a former market participant and currently an academic specializing in international finance) that, especially after the Argentinean experience, the problem of rogue debtors is as critical as that of rogue creditors.

Ms. Schneider pointed out the discontent with present mechanisms for both private and official debt amongst all stake-holders. She questioned the role of the official sector, credit rating agencies, and the criteria adopted by creditors. In response to the Belize case study she argued that collective action clause based debt restructuring had only provided breathing space in Belize. Referring to the problem of serial rescheduling in Paris Club debt restructurings, she pointed out that short consolidation periods were chosen by creditors to keep debtors on a short leash. This combined with the mistakes in projections by the IMF had a snowballing effect on debt because of bunching of repayments due to lower grace periods; market interest on non-ODA on new reschedulings; and new credits issued after debt reschedulings. She questioned why lenders continued to pour money after a rescheduling and what reforms can be undertaken to ensure responsible lending. She provided evidence that transparency had not led to better assessments by creditors.
Ms Schneider argued that there were problems in the signaling mechanism in the world economy. The signals sets out by the IMF were over optimistic affecting the viability of a debt restructuring. The dominant bottom-up (surveillance has a strong country orientation) approach yield consistently overoptimistic forecasts for certain regions and does not sufficiently pick policy spillovers in a global context. Credit ratings by credit rating agencies also fail to pick up country differences in the levels of riskiness.

The IMF, according to Ms. Schneider has become increasingly involved in mediating debt-rescheduling agreements between debtor countries and official creditors through its role in the Paris Club and through this role the financing of a Fund Programs has often become dependents on debt relief. The amount of debt relief is contingent upon a Fund Program and its estimate of financing gap and debt sustainability analysis. Improvements are needed in the estimation of these by the IMF. There is no compatibility between the role of the IMF as gatekeeper for concessional resources and, on the other hand, creditor and therefore a stakeholder in the inflow of the same resources. There is thus an issue of moral hazard at the BWIs.

IV Some Issues in Low Income Countries[8]

In recent years some inter-related themes have been subjects of policy debate. The issue of scaling up of aid flows to developing countries, IDA allocation on the basis of a new joint IMF World Bank debt sustainability framework for low-income countries and whether increased lending by some non-OECD members can be termed free riding on the

Policy and Institutional Assessments (CPIAs) performed by the World Bank to determine debt distress, the implementation of the IDA 14 Grant Allocation Framework and the MDRI and HIPC Initiatives. In particular, he stressed the importance that low income countries that have benefited from debt relief avoid future accumulation of unsustainable debt levels. Mr. Kappagoda also criticized the indicators used to determine debt sustainability levels, and argued that the present approach raises a number of conceptual and analytical issues. He then highlighted the challenges ahead, calling for a continuing review of various aspects of DSF in the context of its objectives to assist lower income countries avoid the accumulation of unsustainable public debt levels and provide a mechanism for the IDA to assess grant-eligibility for IDA-only countries. In particular, he proposed reviewing debt indicators and thresholds, integrating domestic debt into the DSF, monitoring vulnerabilities arising from non-concessional commercial borrowing, fostering creditor coordination, improving data quality and reporting to the international financial institutions and improving public debt management.

Free rider Assessment by the Fund and Bank

Mr Odedokun reviewed trends in non-concessional borrowing in low income countries, illustrating that countries rich in natural resources and countries in conflict account for the bulk of non-concessional debt stock and flows, particularly public and publicly guaranteed types. He in particular highlighted the geographical concentration of this type of bilateral lending, warning that this could make borrowers more vulnerable. Mr Odedokun also assessed the World Bank's document on anti-free riding policy proposal, pointing out the positive aspects as well as the drawbacks of this[9]. On the positive side, he mentioned that the proposal should contain opportunistic lending to low income countries and the subsequent moral hazard problems. It should also serve to discourage lower income countries from undertaking excessive borrowing prior to strengthening their debt management capacity. On the other hand, he asserted that the World Bank should not see itself as a competitor to other creditors and highlighted the problematic aspects of IDA assistance to lower-income countries as well as the need for additional finance to facilitate the achievement of the MDGs. Finally, Mr Odedokun presented some recommendations for ensuring debt sustainability in low income countries. These included the suggestion that borrowing countries should strengthen their governance and macroeconomic management capacities, as well as refrain from borrowing recklessly. At the same time, he stated that the World Bank should promote debt management capacity in low income countries and help them diversify their export base.

Summary of discussion

Mr. Antoniou noted that the macroeconomic implications of scaling-up aid flows are still an unsettled issue. Countries should work to improve absorption capacities and also strengthen their policy fundamentals and governance. While acknowledging the merits of Ms Schneider's proposal to set up a new trust fund to intermediate aid flows, Mr.

[9] In March 2006, the World Bank prepared a paper for its Board on how to deal with the problem that free riding poses for it. In this particular case, a free rider is used to refer to situations in which IDA's debt relief or grants could potentially cross-subsidize lenders that offer non-concessional loans to recipient countries.

Antoniou questioned whether there would be support for the establishment of a new institution. He pointed out that there is also the issue of how disbursements by such a fund could be synchronized with recipient countries' monetary policies. Mr. Antoniou also suggested that CPIAs should include a provision related to the attainment of the MDGs and, moreover, agreed that the World Bank sees itself as a creditor competitor. He finally suggested that the Commonwealth Secretariat should use its technical capacity to assist developing countries in implementing General Equilibrium Models for macroeconomic management.

Mr. Reisen expressed his concern that internationally agreed targets of ODA are not being met. He also warned about the misinformation surrounding the aid debate, noting that the recent increase in donor flows is largely explained by debt relief. Mr Reisen also commented on the build up of domestic debt in many low income countries as a result of sterilization policies, arguing that this is not an issue if private credit is not crowded out. He then dwelled upon the rise of China as a key donor to Africa, pointing out that China's engagement could well represent a new strand of the aid architecture. According to Mr. Reisen, Chinese finance has enabled infrastructure building in Africa is proceeding at a faster pace and lower cost. He also called for the strengthening of standard and codes in critical sectors in less developed regions.

IV Some Issues in Low Income Countries (Continued)[10]

Debt Restructuring

Mr Aliyu gave a historical account of Nigerian external debt restructuring with the Paris Club and the London Club as well as of domestic debt restructuring. He stressed that the need to restructure bilateral official debt arose as resources needed to be released to tackle the unsustainable levels of poverty in the country and the commitment to attain the MDGs. This was reinforced by the election of a new democratic government in 1993, and the ensuing entry of the notion of "odious debt" into the political discourse. The basis for negotiation was the policy instrument agreed with the Dcom

Domestic Debt Architecture in the Context of the Millennium Development Goals

Mr Dohdia reminded participants that the attainment of the MDGs represents a major challenge for low income countries. While it is important to scale up ODA and external debt relief, he also emphasized the importance of freeing up the resources currently employed to service domestic debt and redirecting these towards the MDGs. He also pointed out that the level of domestic debt in many low income countries is underestimated because of data deficiency, is characterized by short maturities and sole to a concentrated base of investors. While expounding the rationale for domestic debt relief, Mr. Dohdia suggested a number of initiatives that low income countries should implement to manage the domestic debt burden, including improving information and databases on domestic indebtedness; promoting debt sustainability, with a view to freeing resources to attain the MDGs; focusing on sound policies that both promote growth and ensure macroeconomic stability; and restructuring existing debt. He pointed out that donors could assist this process through providing appropriate financial and technical assistance.

Mr. Vijay Kumar addressed the issue of remittances and microcredit, stressing their potential positive impact on poverty reduction if the adequate infrastructure is put in place. Focusing on Uganda, which is one of the countries where the Commonwealth Business Council is currently working, he highlighted the importance of developing the banking system, reducing transactions costs and strengthening governance. Pointing out that remittances represent a significant fraction of capital flows in Uganda, Mr. Kumar argued that they are hindered by high transaction costs. To address this issue, the Commonwealth Business Council has recently introduced a new e-banking transfer system. Mr. Kumar also illustrated that microfinance in Uganda is characterized by high interest rates, poor geographical reach, low transparency and minimum competition. Microcredit institutions there also lack technological development and economies of scale. He mentioned that the Commonwealth Business Council is working to build appropriate infrastructure to make microcredit work more effectively in Uganda and, in particular, is active in introducing ATM, back office facilities and mobile technology.

Summary of discussion

Ms. Nissanke, building on Mr. Dhodia’s presentation, argued that the underlying factor behind the unsustainable debt levels faced by many low income countries is low growth.

Ms. Johnson argued that the fact that donors do not deliver aid on time serves to aggravate the pressures of indebtedness of many countries. She pointed out that domestic borrowing is necessary if low income countries want to achieve the MDGs since external financing, including aid, is inherently volatile. She also noted that in many instances donors have been pushing for the development of capital markets in countries where this may not be appropriate. These countries usually lack the required physical, legal and technical infrastructure for capital market development. It is, therefore, necessary that financial development is characterized appropriate sequencing and capacity building.

V. The Monterrey Process on Financing for Development: The Road Ahead[11]

concessional lending to finance country-owned development strategies and actions that ensure debt sustainability.

Aid allocation: The present system of aid allocation is leading to the problem of donor darlings and donor orphans raising questions about the signaling mechanism for aid delivery. In addition donor flows are characterized by volatility and herding. In the case of donor darlings, surges of aid flows in some recipient countries have lead to sterilization costs as the aid flows were very high as a percentage of GNP. The sterilization costs have been in the form of high domestic debt constraining the fiscal policy space for development expenditure. Policy action is needed to improve aid context of the experience of countries such as China. In addition, factors such as the functional distribution of income may also have a bearing on the type and level of investment.

Taxation

The capacity of developing countries to tax has been greatly undermined in recent years and that ways of overcoming this problem need to be examined. At the UN, much more work has to be done to advance international cooperation on taxation in order to reverse the current race to the bottom as governments lower taxes to attract investors with 'beggar thy neighbor' consequences. All too often, developing countries' capacity to tax has been greatly undermined with the reforms which have taken place over the last couple of decades. The ability to overcome such problems is extremely important for restoring fiscal space and government capacity to act developmentally and equitably.

Employment generation

How countries can transition from vicious to virtuous cycles of growth and creation of employment? This needs to be studied in the context of recent experience where there has been an improvement in growth in developing countries that has little to do with economic reforms and, moreover, has not led to a significant increase in employment. Here, there are at least two issues: In the last half decade, there has been more growth in many developing countries, but this has had very little to do with preceding economic reforms. We have to better understand what made recent growth possible, including higher commodity prices as well as lower intere

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The four pillars to move forward are:

1) Regional cooperation programs
2) Trade & investment cooperation
3) Monetary integration
4) Public goods integration

Savings need to be mobilized with the help