Report
Multi-stakeholder Workshops on Debt, Finance and Emerging Issues in Financial Integration

The Financing for Development Office organized two workshops on "Debt, Finance and Emerging issues in Financial Integration" with financial support from the Government of Norway. The first workshop was organized in partnership with the Commonwealth Business Council and Commonwealth Secretariat in London on 6 and 7 March 2007 and a follow-up workshop on 7 and 8 April 2008 in New York[1] 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 discussions and papers[2] fed 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, held in Doha (29 November-2 December 2008).

The workshops consisted of plenary sessions and presentations of substantive papers to initiate discussions as well as panel discussions on the policy issues in financing development on the Road to Doha. The mix of speakers and participants from international organizations, private sector, civil society and academia added to the richness of the discussions and represented views across the board. The papers were made available on the Financing for Development Office website[3]. The New York workshop was well attended by delegates, eliciting active participation and interest in the substantive papers presented at the meeting. The discussions with delegates continued well after the workshop was over, also in the preparation for the Doha Conference.

Meeting 6-7 March 2007, Commonwealth Secretariat, London (report submitted)

Meeting 8-9 April 2008, United Nations Headquarters, New York

The conference was opened by H.E. Johan L. Løvald, Permanent Representative of Norway to the United Nations, H.E. Maged A. Abdelaziz, Permanent Representative of Egypt to the United Nations, Co-Chairs of the preparations for the Doha Review Conference and Sha Zukang**,** Under-Secretary-General for Economic and Social Affairs.

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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

The opening remarks covered the modalities and process for the preparatory work for the review of the Monterrey Consensus in Doha in December 2008. It was recognized that the workshop could provide important input to

decision making processes. The new voting formula that was recently decided by the IMF Board is fundamentally flawed.

Financial crisis: The need for a better regulatory framework
There is a serious predicament in the international community which impedes (or hinders) fully grasping and resolving the current financial turmoil. Short-term policy solutions may not be sustainable, and there is an urgent need for a better regulatory framework for the long term. Debt issues to be discussed here were enriched by the concept of debt sustainability with growth and development. The issues are relevant for the preparations for the Doha Review Conference.

The second speaker, **Roger Kubarych**, covered the issue of securitization, which is at the heart of the subprime mortgage crisis.

Securitization: Regulatory practices key for success of securitization
In Roger Kubarych's view, while the securitization of financial assets can be beneficial to economic development, prudent financial supervision and regulation are a prerequisite for well functioning financial markets. He explained that securitization in the United States was initially driven by government sponsored enterprises and backed by high quality mortgages. After these public enterprises overexposed themselves with mortgages in their own portfolio and lost public trust due to increased risk exposure, the private sector took on a leading role in home mortgage financing and securitization.

While privately securitized mortgages as a share of overall mortgage financing in the U.S. increased from 7.5% in 2000 to 19.8% in 2007, the financial regulatory system was ill-equipped to tackle abusive lending practices. Moreover, poor judgments and conflicts of interest exacerbated the speculative housing bubble.

Lessons on securitization for emerging economies

- Emerging market countries with large holdings of assets in global capital markets should seek to minimize their risk exposure by relying on market analysis from independent financial experts (not by ratings agencies).
- Countries with current account deficits (net recipients of flows) should diversify their sources of funding with a special commitment to attracting private equity capital.
- The domestic banking sector should be allowed to provide credit without politically-motivated directives.
- Prudent financial supervision and regulation have to be established and the oversight of risk-taking and financial health of domestic banks should be exercised by the central bank.
- In order to benefit from securitization of mortgages and commercial loans, it is a prerequisite that a financially capable buying side is in place that has the capacity to evaluate the underlying risk of securitized instruments. Institutions with the capability to carry out such risk evaluations independently are insurance companies, pension funds and other financial institutions.

M.V. Leeladhar, the third speaker, presented the Indian experience with CAL to illustrate some lessons in opening and managing the capital account.

Capital account liberalization: Lessons from the Indian experience
The main elements of external sector policies in India are: (a) maintenance of an acceptable level of current account deficit, (b) market determined exchange rate regime, (c) building up reserves by encouraging non-debt creating flows and de-emphasizing debt creating flows, particularly short-term debt, and (d) creating an enabling environment for foreign direct investment.

Active capital account management has been exercised by the central bank in order to avoid the negative impact of the substantive increases in capital flows such as large domestic liquidity movements and the consequent distortion of market exchange rates and interest rates. The policy instrument of interest rate increases to sterilize excess liquidity has had a limited effect, as it does not only pose a risk to economic growth, but also increases the possibility of further capital inflows. While it is necessary that banks hedge their exposures to currency and interest risks associated with sudden reversals in financial market sentiment, more durable policy responses by the government are necessary for enabling the absorption of capital flows into productive capacity. Capital outflow liberalization is a limited short-term policy instrument, since such a regime attracts more capital inflows. The active management of the capital account requires a conscious choice in terms of a hierarchy of capital flows. In this context, long-term capital flows are generally preferred over short-term capital flows. In the face of large capital flows the exchange rate policy of central banks should be guided by the principle of careful monitoring and flexibility in the management of exchange rates without deciding on a fixed target or pre-announced target or band, coupled with the ability to intervene if necessary.

Roy Culpeper, the fourth speaker in the first session covered some additional issues relevant for the Follow-up to the Monterrey process.

Growth: A key issue – how can growth be sustained?
Since Monterrey, growth performance in developing countries has been remarkable particularly in Asia, driven by trade and investment. One key question for the Doha Conference will be whether current economic growth path can be sustained and how?

Climate change: how will additional resources be mobilized?
It is especially the poorest countries, that are least to blame for the problem, that will be affected by climate change, which may result in large scale environment migration. The associated adaptation and mitigation costs of climate change are going to be very high and more than what the aid system can manage. A key question will be how additional financing can be mobilized?

Financial crisis: A failure of the International Financial System

The failure of the international financial system to bring down global imbalances indicates the urgent need for reform of the international financial systems. The timid moves towards improving multilateral surveillance have not yielded results. The impact on the real economy is still unfolding.

National development strategies: How will each chapter of the Monterrey Consensus support National Development Strategies?

- Policy approaches towards an inclusive financial sector have to go beyond the concept of Microfinance. This would require financial sector development that provides financial services for all groups in the population, in particular the poorest citizen.
- The main policy tool of the IMF for the management of capital flows is aggregate demand as opposed to interventionist polices. This needs a re-think
- The recent cutbacks in the joint Financial Sector Assessment Programs (FSAPs) of the IMF and World Bank are surprising in the context ot the global environment, where there is a renewed emphasis on regulation.
- The international trade regime has to ensure that latecomers can follow their own development strategy.

Session II: Emerging Global Issues in Financial Integration

John Williamson: Crises and International Policy Coordination

The emergence of the credit crunch has given global imbalances a new quality. Emerging markets will not be immune to the US slowdown and will have to adopt expansionary policies. If surplus countries like China exercise a policy shift from export led growth to expanding domestic demand, this could lead to a crisis of confidence of foreign investors in the US economy, coupled with a further collapse of the US Dollar and thereby heading off to an unwinding of global imbalances. However, it is gratifying that financial turbulences to this point have not been associated with a loss of confidence that brings a major fall of investment in the United States.

Williamson argues that the prime responsibility for the financial turbulence is to be found in inadequate supervision. The authorities welcomed the process of securitization and its corollary, the originate-to-distribute model, without adequately weighing the dangers they inherently bring in terms of increased susceptibility of the financial system to crisis. Strengthening financial regulation on a global level is needed for avoiding future crises. Furthermore, macroeconomic policy coordination is necessary to limit global imbalances and the Yen carry trade.

It is desirable that any changes be introduced essentially simultaneously in all the major financial markets; otherwise there is the danger of the benefits of reform being lost due to regulatory arbitrage. If that is classified as policy coordination, then coordination is central to achieving a more robust system. The more traditional form of coordination, in which the authorities of the leading countries

Avinash Persaud: Adequacy of International Reserves:

Persaud argued that it is only by changing incentives in the financial system and the regulatory framework can we prevent future crises. The Basle regime has fundamental flaws. It puts market prices at the center of focus and looks at risk to be taxed, forcing risks to move to another area where they cannot be seen. We need to leave risks visible and regulators should use risk-modeling. The banking sector is privatizing returns but socializing risks and influences policies and regulators.

Most small open economies prefer fixed exchange rates. In emerging markets two-corner exchange rate solutions have been dropped in favor of more reserves, coinciding with strong growth, thus providing liquidity insurance to financial markets. Sovereign wealth funds are very different from reserves, which were mostly used for exchange rate crisis management. Indian reserves have risen eight fold while imports have doubled. But financial integration was fast advancing, requiring reserves against short-term outflows.

India's reserve position is much healthier if the market valuation of equities is taken into account. Short-term debt was key in recent crises. The situation with equity is very different. If equity is issued to finance a firm, risk is on shareholders, but exiting equity portfolio flows also cause pressure on a country's exchange rate. Data suggest that equity is less volatile than short-term debt and now plays a key financing role. We have had a long period of equity investment, but no longer dedicated, rather equity investments by cross-over investors. However, equity value is more volatile. The biggest problem today is that emerging markets are not any longer dominantly exposed to short-term external debt, but rather to cross-border equity based capital flows. While portfolio equity flows like FDI have been characterized as long-term investments, financial liberalization and innovation has undermined this distinction. Investors can borrow against illiquid, long-term liabilities and create liquid short-term counterparts.

The level of foreign exchange reserves is hardly excessive for most emerging market ly use6(r Twevel 6)5.66(foreign ex)5.les is taken-6.3(d a)]TJ25 TD0.00six. T
economies. By taking into account financial liberalization and innovation in determining
risk for developing countries, w, w, w7-0.r flow.052ro.aeralizal3-r4wo-y-0. e pon9 e9wlxchanwhe innovat

who can bear it but did this did not work that well. Emerging Europe is catching up, but with rising debt versus reserves build-up in other emerging markets, especially in Asia. FDI and portfolio equity liabilities are rising everywhere as percentage of GDP. Milesi-Ferreti questioned the validity of traditional indicators of reserve adequacy with the changing nature of vulnerabilities and risks.

Discussant: J.A. Ocampo agreed with most of Williamson's analysis but disagreed with some of the recommendations. The wealth effect of dollar depreciation is borne by the rest of the world and is more important than Williamson indicated. His strong remarks about securitization belittle its benefits for development of debt and mortgage markets as in Chile. His view of the financial market is one of strong procyclicality. Regulation can offset it, but marking to market exacerbates it. The third issue is overleverage of a systemic character while some of the innovations were for evading the need of more capital. These are major problems facing financial regulation.

Debt insurance does contribute to global imbalances as costly individual defense versus collective insurance. Volatility of equity flows can be quite high and has an indirect effect on prices of domestic assets adding to procyclical flows.

Session III: Issues in Public Debt Sustainability and Debt Management

Jose Antonio Ocampo and Camilo Tovar: External and domestic financing in Latin America: developments, sustainability and financial stability implications

Latin America witnessed unprecedented growth, which has come along with a major change in financing patterns. A favorable macroeconomic environment in Latin America, characterized by economic growth and current account surpluses, sustained capital flows mainly in the form of FDI has improved the region's international investment position and reserve accumulation significantly, thereby strengthening the region's capacity for self-insurance. It has also led to a shift from cross-border to domestic financing and, domestically, from bank to bond financing. As a result, domesticDebt insurance doe9view of9c fin

- lack of a proper infrastructure and regulatory framework. These are all potential sources of instability that need to be assessed.

Thus, the development of local currency debt markets has led to progress in the reduction of currency mismatches, but these markets are nevertheless characterized by short-term biases and have not solved problems of market liquidity (low level of secondary market trading). It remains to be seen if the progress made so far will make the region better prepared for a more prolonged turmoil in global financial markets and will provide leeway for countercyclical macroeconomic policies. The development of large and deep markets for corporate debt remains unfulfilled in most countries of the region. It is an area which would require a structural policy response.

Heiner Flassbeck and Ugo Panizza: Debt Sustainability and Debt Composition

While the debt situation has improved considerably in developing countries, the high level of self-insurance is an indicator of shortcomings in the international financial system. Vulnerabilities exist in particular with respect to a lack of debt indicators that take into account both the level and composition of debt. Most debt sustainability analysis mixes the concept of external sustainability with that of fiscal sustainability.

There is still confusion with regards to the clear definition of fiscal sustainability and the benchmarks which need to be met which would define a country's policies as fiscally sustainable.

There are three key lessons which have been emphasized that need to be taken into account while analyzing external sustainability:

(i) Calculations of government debt sustainability may be misleading and analogies used to evaluate the former should be discouraged from use.

(ii) *Foreign debt* as a result of negative exogenous shocks is *never sustainable* (other than when a future positive shock of equal magnitude is expected).

(iii) A thorough analysis of *causes of indebtedness* should be executed while measuring sustainability needs. It should be noted that analysis based upon debt levels and forecasts of some macroeconomic variables lead to highly inconclusive results.

While developing countries have made progress by shifting debt from cross-border to domestic financing (e.g. Bonds in domestic currency) and to financial instruments that could limit cyclical vulnerabilities (GDP indexed bonds), there is an urgent need for domestic debt to be included in Debt Sustainability Analysis in order to account for new vulnerabilities.

Better data are necessary because debt sustainability analysis should focus on total debt and study the implication of the debt structure. A better analysis would take into account data on the composition of debt (maturity, currency, type of holders) and build an aggregate debt ratio where riskier types of debt have a higher weight than safer types of debt. The main obstacle to conducting such research is data availability.

The empirical analysis comes to the conclusion that when comparing external public debt with private creditors in foreign currency, domestic public debt and external public debt with official creditors, the first is associated with the highest risk, while the latter with the lowest.

Tomas J. Balino and V. Sundararajan: Public debt management in developing Countries: Key Policy, Institutional and Operational Issues

The World Bank and the IMF have made important efforts over the past decade to develop public debt management guidelines, which are taking into account the different degree of development in member countries and are meant to assist developing countries to reduce borrowing costs. While it is common practice for OECD countries to have a published debt management strategy, a recent survey of developing countries conducted by the World Bank found that only half of the sample countries had such a strategy and that publication of the strategies was even rarer.

The structure of public debt has changed significantly in a number of emerging market economies, due to significant debt restructuring operations over the last years. In an environment of high liquidity and low interest rates, emerging market economies have reduced their external liabilities and have domestic financing substituted for foreign debt. Additionally, more than 20 emerging market sovereigns have taken advantage of financial innovation and changed their debt profiles by arranging for swap credit lines with international banks.

In low-income countries foreign debt was significantly reduced by debt relief initiatives. However, due to the lack of adequate transparency practices and coordination between the different debt agencies in most of the HIPC countries, debt management has actually worsened. It would be important to provide additional technical assistance for this group of countries to improve their debt management capabilities.

Asset-liability management (ALM) is a key instrument in debt management for analyzing risk and cost trade-offs. However, modeling costs and risks using ALM are complex and only very few countries have so far begun to work with this framework. Therefore, a simpler approach, focused only on certain assets and liabilities may be more attainable for the majority of countries.

While country ownership is important in public debt management, the international community can encourage and support countries in applying WB/IMF guidelines in public debt management. However, it is important that the application of guidelines does not lead to a distortion of priorities, as it will not always be optimal for developing countries to devote all resources needed to obtain perfect scores in assessment.

Any such authority will be dependent on the prior contractual agreement to arbitration by all of the relevant parties. The introduction of an arbitral tribunal will depend on a pre-crisis consensus among the parties. This makes it critical to include an arbitration clause in each respective issuance of sovereign bonds – similar to the inclusion of CACs. The tribunal will not have any intrinsic authority to initiate and decide cases on its own. At a minimum, the tribunal should be empowered to address matters related to the verification of claims as well as voting issues related to the approval of the restructuring plan and other similar matters. Binding effect extends only to those creditors who have agreed to subject themselves to arbitration by signing the contract containing the arbitration clause.

The relevant trigger for invoking arbitrage mechanism is the announcement of a default. The creditors would have to develop and specify a mechanism for creditor representation. Mediation could be the precursor to a binding arbitration procedure. Financing and support for the tribunal should come from the sponsoring organization.

Discussant: **Anna Gelpern**, **A**ssociate Professor of Law, Rutgers School of Law-Newark, The State University of New Jersey, Newark

- Debt resolution decisions should be taken out of IMF because of stringent economic and political conditionalities.
- Standing dispute resolution mechanism (tribunal) could be a step towards a more ambitious regime.
- The 2003 Security Council Resolution on Iraq debt stated that the oil resources were immune to any kind of attachment. At the time IMF was proposing its debt-restructuring model for developing countries, which in turn was seen as too intrusive by market participants. This resolution reflects all the problems of the current mechanisms and the two papers focus on offering better alternatives. Steve's proposal could become an ambitious and permanent solution to many of the problems. Still the resolution of possible debt of countries stuck in a permanent receivership or with the so-called "odious" debt would be very different.
- There should be more research of domestic debt contracts.
- Concerning the tribunal, building institutional credibility is key.
- Dealing with vulture funds should be seriously discussed.

Session IV: LICs' Access to Finance

Farhad Noorbakhsh, **Luis Angeles**, and **Celine Azemar:** Selectivity and aid allocation: is there an improvement?

The paper analyzed the behavior of donors over the period 1984-2003. It tests whether there has been a change in the behavior of donors since the late 1990s (since the HIPC initiative) and if aid has become more selective. The econometric analysis examines three

types of determinants, recipient country needs, recipient country merits and the interest of donors.

Some of the findings of this study are that commercial partners, ex-colonies and countries with a special geopolitical situation tend to receive more aid. Since the late 1990s foreign aid has become more focused towards poorer countries. At the same time, bilateral trade has become less important as a predictor of foreign aid flows.

There is no evidence that democratic regimes attract more aid than they used to or that countries that achieve low inflation rates are better regarded than those that do not. In other words, there is no strong trend towards selecting countries with good policies and institutions.

It thus appears that the neediest and most meriting countries receive more aid, emphasizing positive selectivity of donors for the observed period. Post 1998, there is a change in donor behavior. The World Bank is the donor that has the most important improvement in terms of aid selectivity after 1998. The authors find a clear improvement

The author suggests that emerging economies should not only come up with their own IDA subscriptions but also help LICs pay for their allocations in the framework of South-South solidarity. The increased voting power of developing countries in IDA might also help reduce industrial countries influence in areas where IDA works closely with the

To sum up, this paper concludes that stock markets may be potent symbols of capitalism, but paradoxically capitalism works as well, if not better, when stock markets do not have a major role in the economy and this is the main lesson from the perspective of economic development in emerging countries.

Discussant: Rob Vos

Aid allocation analyses have never been very convincing. In ai

an awareness of capital flows volatility and devote effort and resources to the

Discussant: B. Guha,
Guha noted that capital account opening and its regulation in Africa is very well described in Mosley's paper. The effect of financial development's on economic development can be positive or even negative, according to literature. Even FDI flows do not necessarily lead to long-term growth. For instance, NAFTA has led to skilled labor emigration from Mexico.

The potential of capital flow reversal goes down only if flows are committed over the long-term to the country. It is unfair to expect developing countries to subscribe to international standards handed down by developed countries. It makes sense to look deeper into local practices before trying to change them. The challenge of the impossible trilemma can shed light on the cautious approach adopted by countries such as China and India.

In the second paper, the authors chose two ways to tackle the linkages. Aid for trade is a second best argument, policy coherence is more important. The donor community should look for ways to embrace all three objectives the authors proposed for aid for trade, with possible sequencing of policy measures. Export diversification and moving up the value change is a preferred option for resolving the tension between debt, aid and market access.

Jomo Kwame Sundaram: Concluding remarks

It is appropriate to have a distinction between global imbalances and the economic and