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rivate capital f ows

to developing countries in recent years, this issue continues to be important for a large majority of low-income countries as well as several middle-income countries.

• Securing greater international f nancial stability. This problem has been put aside in re-

cent years because of the complacency brought about by favourable cyclical global economic conditions since the early years of the decade,

including a surge in capital inf ows, favourable payments and reserve positions and a relatively high degree of stability of exchange rates in most developing countries. However, the systemic problems have not disappeared. There are serious risks and fragilities in the international economic system including large and persistent trade imbalances, instability and misalignments among reserve currencies and the vulnerability of many emerging markets to a reversal of favourable cyclical global f nancial conditions. dif culties, on

B. External Financing

Need for more development f nance

Collectively, since the early years of the decade, developing countries have been able to generate adequate resources (savings and foreign exchange) for development. This is best ref ected

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* This note draws on Y. Akyüz, *Reforming the Global Financial Architecture. Issues and Proposals*, Zed Books, London, 2001; 'Reforming the IMF: Back to the Drawing Board'. *G24 Discussion Paper 38,* UNCTAD 2005; and 'Rectifying Capital Market Imperfections: The Continuing Rationales for Multilateral Lending', in *The New Public Finance. Responding to Global Challenges*, ed. by I. Kaul and P. Conceição, OUP, 2006.

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est rates, high levels of liquidity and, again, oil surpluses. Capital inflows in the current cycle have exceeded the peak observed in the previous boom, reaching some $500 billion, and most middle-income countries have shared in this recovery. The majority of such flows are short term in nature, driven by interest arbitrages (carry trade) and increased private sector borrowing from international markets. They are also attracted by asset acquisition in emerging markets. The result is again increased financial fragility, as asset prices and exchange rates in many countries have been raised beyond levels justified by economic fundamentals. Price bubbles have pushed the return on financial assets to double-digit levels, more than twice the growth rate in the real economy. The inflows have also made it relatively easy to finance current-account deficits, promoting unsustainable exchange rates in some emerging markets. Certain speculative elements driving the recent global financial boom including excessive risk taking and leverage have been laid bare by events in recent months. The boom now appears to be nearing its end under circumstances characterised by a combination of persistent and growing global trade imbalances, increased volatility of the dollar and growing tensions in the trading system. Once again countries dependent on external private capital flows for balance-of-payments financing face the risk of collapse of growth as global financial conditions tighten while others excessively dependent on foreign markets may experience a sharp slowdown in economic activity.

Foreign direct investment (FDI) is often promoted as a more reliable source of development finance. Much of it going to developing countries has been in the acquisition of existing assets rather than new (greenfield) investment to expand productive capacity. Initially this was driven by privatisation of public assets but more recently there has been increased acquisition of private assets in the developing world by multinational companies from industrial countries. Greenfield investment in manufacturing goes primarily to countries with strong and sustained growth potentials – it tends to lag rather than lead growth. Despite the claim of the BWIs that the recent upturn in FDI to poor countries reflects improving performance and better investment climate and growth prospects, evidence shows that a chunk of this has been going to the exploitation of rich minerals and oil reserves in a handful of post-conflict countries or to countries with newly discovered oil and mineral resources.[1]

Quite apart from generalised global boom-bust cycles, private capital flows to developing countries tend to be pro-cyclical. Many countries find their access to short-term liquidity and trade credits curtailed at times of adverse movements in commodity prices and terms of trade – that is, when they are most needed. Rapid withdrawal and exit of funds at such times force countries to pursue pro-cyclical monetary and fiscal policies in an effort to accommodate external shocks and to regain confidence of financial markets, thereby aggravating deflationary impulses generated by external shocks.

Multilateral lending

Multilateral financial institutions are increasingly becoming a burden, rather than a relief, for developing countries. In every year since 1991, net transfers (that is, disbursements minus repayments minus interest payments) to developing countries from the International Bank for Reconstruction and Development (IBRD) have been negative. Since 2002, net disbursements have also become negative. In effect, taken as a whole, the IBRD is not making any contribution to development finance other than providing finance to service its outstanding claims. It is much the same for regional development banks. The problem here is that, for reasons related to conditionality and bureaucracy, countries which are eligible for IBRD loans are generally unwilling to borrow as long as they have access to private markets, even when this means paying higher rates. On the other hand, many poorer countries which need external financing are not eligible for IBRD loans. These difficulties underline the recent initiatives taken by the Bank to reduce charges on loans to middle-income

countries and to make a substantial transfer from its income to its concessional f nancing facility, the International Development Assoica-tion (IDA).

Indeed, the IDA is the only source of net f nance for developing countries from the World Bank. However, quite apart from the problems associated with the dependence of the Bank on a handful

grants – a step that needs to be taken since many IDA countries are already highly indebted and in need of a substantial debt write-of .

Reforming of f cial f nancing

Thus the f rst step should be to separate bilateral and multilateral arrangements for development f nance and debt. Certainly, it is up to sovereign nations to enter into bilateral agreements on debt and f nancing, but these should be kept outside the multilateral system. This means taking the donor-driven facilities out of the BWIs; that is, the IDA from the World Bank and the PRGF from the IMF. The amounts involved are quite small, but the impact on the governance of these institutions could be important.

The European Union has created a trust fund to disburse the European aid to f nance African infrastructure without depending on the World Bank, on grounds that its aid money should be spent according to European policies but the EU does not have the inf uence it should in the World Bank. This move demonstrates once again the predominance of political considerations in the provision of aid. It is a welcome initiative in so far as it helps separate bilateral from multilateral lending, but it should also accompany steps to make the World Bank a genuinely independent multilateral development f nance institution.

There is no justif cation for the Fund to be involved in development and poverty alleviation. It should focus on the provision of short-term liquidity to countries experiencing temporary payments shortages, including poorer countries which are particularly vulnerable to trade shocks, in order to enable them to weather temporary adverse movements in balance of payments without suf ering from large losses of output and employment. This is very much needed in view of the pro-cyclical behaviour of international f nancial markets. The Fund should thus revive the CompensatoBpenTjSpTextpenTjSpTexdm[m231TjEMC 2572 0 Td3y2(u)-3(r)]200238jE

Many of the problems encountered in multilateral development finance and policy advice could be addressed if the World Bank went back to its original operational modalities and concentrated on facilitating capital investment through project financing, rather than trying to fix all kinds of policy and institutional shortcomings in developing countries through structural adjustment and development policy loans. It should cease to be an aid institution and become a development bank, intermediating between international financial markets and developing countries. As originally envisaged, its financing should be provided in loans rather than grants, and made available only to countries which do not have access to private capital on reasonable terms.

Such arrangements would still leave a key problem

C. International Financial Stability

There is a growing recognition that f nancial
instability is global and systemic, af ic c, ere

The failure of IMF surveillance in preventing international f nancial crises also ref ects the unbalanced nature of the procedures which give too lit le recognition to shortcomings in the institutions and policies in major industrial countries with large impact on global economic and f nancial conditions. Its surveillance of the policies of the most important players in the global system has lost any real meaning with the breakdown of the Bret on Woods exchange-rate arrangements. Standards and codes have been designed primarily to discipline debtor developing countries on the presumption that the cause of crises rests primarily with policy and institutional weaknesses in these countries. Since these are based on best practice in industrial countries, the lat er have no obligations to undertake new action to meet such standards.

Lit le at ention has been given to the role played by policies and institutions in major industrial countries in triggering itntn[nt+ s rgi nstuchirtg n q ion

So far neither IMF surveillance nor consultations within the G 7 have been ef ective in securing an appropriate mix and stance of macroeconomic

the currency and hikes in interest rates, thereby deepening economic contraction.

There have also been suggestions to turn the Fund into an international lender of last resort with a view to helping prevent crises. There are dif culties in transforming the IMF into a genuine international lender of last resort, including lack of discretion to create its own liquidity and the terms of access. But the most serious problem is that rescue packages tend to aiggrav Ú n

heads of the Bretton Woods institutions between the two shores of the Atlantic has survived widespread public criticism. The latest selection of the Managing Director was again business as usual with Europe claiming the position once again. The agreement between the EU and the United States almost guaranteed the outcome since the majority of votes cast in the Board was sufficient for election, and developing countries chose not to nominate a candidate either individually or collectively.

There is a consensus that the present distribution of voting rights lacks legitimacy not only because it does not meet the minimum standards for equity due to erosion of 'basic votes', but also because it no longer reflects the relative economic importance of the members of the Fund. The existing distribution of voting rights, together with the special majority requirements for key decisions, effectively gives a veto power to the United States in matters such as adjustment of quotas, the sale of IMF gold reserves, balance-of-payments assistance to developing countries, and allocation of SDRs. Such a degree of control by the United States may have had some rationale during the immediate post-war years when it was the single most important creditor to the rest of the world and effectively the only creditor of the Fund. However, now not only is the United States the single largest debtor country in the world, but it is only one of the 45 creditor countries at the IMF.

In theory the Fund appears to be a consensus builder since decisions by the Board are taken without formal voting. But there has been hardly any consensus on proposals for change favoured by developing countries in areas such as quotas, voting rights or SDR allocation. The influence of developing countries is further weakened by the practice of arriving at decisions through consensus among Executive Directors, rather than direct exercise of voting rights by each and every member, since many developing countries are represented by Executive Directors from industrial countries.

The procedures followed for the preparation and approval of country programmes also diminish the impact of developing countries. Typically agreement is reached between the country concerned and the Fund staff before a programme is presented to the Board, and it is not always clear to what extent the agreement reached reflects what the country really wants to do as opposed to what it has been compelled to accept. This tends to discourage developing country Executive Directors to oppose potentially damaging stabilisation and adjustment programmes even though in theory they have collectively the required number of votes to block them.

The current distribution of voting rights and the manner in which they are exercised effectively enable the major industrial countries to use the Fund as a multilateral seal of approval to legitimise decisions already taken elsewhere by this small number of countries. Lack of broad participation in the decision-making process is also a main reason why the Fund does not meet the minimum standards of transparency or accountability. There is an increased agreement that despite certain measures recently taken, lack of transparency goes well beyond that justified by the confidential nature of the issues dealt with by the Fund. The record on accountability is even less encouraging: the Fund is protected against bearing the consequences of the decisions taken, and the burden of inappropriate policy choices invariably falls on countries following its advice.

Proposals for reform for reducing the democratic deficit fall into two categories. First, changes could be made to special majority requirements in order to remove the veto power of the IMF's major shareholders over key decisions. Second and more importantly, voting rights could be reallocated to increase the voice of developing countries by raising the share of the basic votes in total voting rights and by reallocating quotas on the basis of Gross Domestic Product (GDP) in purchasing power parity. Recent changes in the distribution of voting rights have removed some anomalies such as Canada holding more votes

than China, but there are still imbalances that cannot be justif ed in terms of relative weights of countries in the