# CHALLENGES IN FINANCING FOR DEVELOPMENT
## Policy Issues for the Doha Conference

The United Nations General Assembly agreed to hold the Follow-up International Conference on Financing for Development in Doha in the latter part of 2008. Thus, it is time for international policy makers, activists and thinkers to ask themselves and each other what are today's challenges to bring to Doha. To support an international process of collective reflection, the New York Office of the Friedrich Ebert Stiftung (FES) organized a retreat on October 4-5, 2007 in Briarcliff Manor, New York at which prospective current representatives and past participants ("alumni") in the FfD process could exchange views in an unscripted and informal dialogue.[1] Forty-seven individuals participated in the dialogue in their personal capacity from governments in the North and South, multilateral institutions, civil society and the private sector.

The Monterrey Summit was an "International Conference" of the United Nations, in cooperation with the World Bank, the International Monetary Fund (IMF) and the World Trade Organization (WTO). The Monterrey Consensus was an international political agreement on economic and financial issues to promote a better life for the people of the world, especially in developing countries. The follow-up process strives for an inclusive multilateralism, insisting on a holistic and coherent agenda and effective participation of all relevant stakeholders including civil society and the private sector. On the way to Doha and beyond, it continues to be an essential political process. Monterrey was a first step to building a global alliance for development. Now it is time for a second step.

This report of the dialogue presents a summary of the discussion of the main themes, as had been proposed by FES, highlighting the conclusions and proposals put forward by various speakers. Conclusions and recommendations are collected in a separate box that follows this introduction for ease of reference. While the authors of this report sought to summarize the discussions and new proposals, readers should not treat the report in any way as a consensus text. It is hoped it will rather provoke discussion as preparations for Doha begin.[2]

[1] The discussions followed the Chatham House Rule, wherein attendees are free to make use of the content of discussions but not attribute any views to any participant. The rule is followed in this report as well.

[2] The report was prepared by Barry Herman, Frank Schroeder and Eva Hanfstaengl.

# Conclusions and Proposals

## International Financial System

1. Developments over the past several months, which showed that the international financial system remains vulnerable to instabilities, point to unfinished business of Monterrey.
2. Efforts are needed to bring about more effective coordination of macroeconomic policies of the world's major economies in the interest of global stability and the growth of wellbeing around the world.
3. The high reserve levels of developing countries reflect their preference for a form of self-insurance, in effect expressing low confidence in the International Monetary Fund (IMF), the designated multilateral institution for prevention and resolution of balance-of-payments difficulties.
4. Rebuilding confidence in the IMF as a central international financial institution seems to require giving more of a governance role to developing countries, and expanding and in some cases redesigning its lending instruments.
5. Despite current reform initiatives, broader international space is required for international financial policy discussion among all relevant stakeholders, including from all interested governments of the North and South, the private sector and civil society.
6. New or reformulated policy discussion mechanisms would help bring about a more internationally coordinated and coherent approach to the standard forms of financial regulations (e.g., banking regulation, insurance, securities markets).
7. Systematic thought needs to be given — as in the international process leading to the Doha Review Conference — to extending the range of financial sector activities that require official oversight (e.g., rating agencies, hedge funds, private-equity funds, asset-backed securities).

## Development Assistance

8. A strong political push for substantial additional official development assistance is essential.
9. Recipient capacity to evaluate and manage aid must be strengthened to more effectively absorb aid flows.
10. The new Development Cooperation Forum of the UN Economic and Social Council, which brings together donors, recipients and civil society, should become a primary instrument for strengthened aid effectiveness.
11. More countries should introduce promising innovative initiatives, like the air ticket solidarity levy. Additional programs - multi- or individual country initiatives - should be explored.

## Prevention and Resolution of Debt Crises

12. The International Development Association (IDA) of the World Bank needs a replenishment adequate to sustain its financial capacity, especially if it is to contribute significantly to the effort to reach the Millennium Development Goals.
13. The concept of debt sustainability should be re-examined so as to more effectively take into account economic and social development.

14. The risks in international borrowing — both by low and middle-income developing countries — should be better shared between debtors and creditors, as by adding flexibility options into repayment terms.

15. There is need for better coordination and responsible lending of all official lenders.

16. New efforts should be put into the design of a credible international mechanism for debt crisis workouts that would bring different classes of creditors together for timely and effective debt restructuring with fair burden sharing.

## Domestic Resource Mobilization

17. Each country has the primary responsibility to design and implement national development strategies, set priorities and decide on an appropriate sequence of government actions for the mobilization of domestic resources.

18. The Doha Conference on Financing for Development should revisit the importance of "Special and Differential Treatment" in trade and financial policies for development.

19. International tax cooperation for development would be advanced if the UN Committee of Experts on Tax Matters were upgraded to an intergovernmental body, where it could reach stronger international agreements.

20. International cooperation for more transparency in the exploitation of natural resources should draw upon the Extractive Industries Transparency Initiative (EITI).

21. The new UN and World Bank Stolen Asset Recovery (StAR) Initiative on the fight against corruption and the need to recover illicitly removed assets from developing countries should be fully supported.

22. Countries need to create more capacity and space to conduct counter-cyclical macroeconomic policies.

23. In order to foster the realization of decent work for all, governments have to ensure adequate levels of public expenditures over the medium term in the areas of infrastructure, social safety-net systems and human capital development.

24. There is a need for a much more inclusive and broad-based approach to financial services for all segments of the population in developing countries. Such an approach should also include the strengthening of access to finance for small and medium- sized enterprises.

## The Way Forward

25. Steps in preparing the Doha meeting should make use of the essence of the Monterrey process, which is to focus on substantive discussion in informal formats. This could include intensive and short-duration multi-stakeholder working groups on specific high priority issues. In addition the UN and other institutional stakeholders should organize regional meetings on salient issues.

26. There is a clear need for a more systematic, continuous and strengthened follow-up process, and thus a more institutionalised mechanism. One proposal is to create a new UN Committee on Financing for Development.

## Risks to Development from the International Financial System

The international financial system is meant to facilitate international trade, investment and world economic growth, and yet it operates much less effectively or evenly than it should or could. The sense of the discussion was that reforming the international financial architecture had to be a high policy priority, especially in the light of international commitments to the development of developing economies and to working for the eradication of poverty worldwide, as also stated in the Monterrey Consensus (section II.F, especially para. 53).

<u>Problems in the international financial system since Monterrey</u>:

- **Developments over the past several months of this year in the United States and Europe showed that the international financial system remains vulnerable to instabilities, as it had in the years leading up to the Monterrey Conference.** The problem this time originated in the market for US sub-prime mortgages (housing loans to risky borrowers). This first unsettled the market for financial securities whose earnings come from mortgages and then spread to other securities markets and banks, affecting financial institutions in Europe as well as the United States.[3] Credit as a whole began to disappear, which threatened a general economic crisis, had not both the US and European central banks lent funds to their banks on an emergency basis. The broad financial and economic crisis was thus averted, although the problems in the US household mortgage market still need to be addressed. The main observation is that distress in one retail market in the United States quickly spread across the US financial sector and to other countries as well. This time emerging markets were largely unaffected. However, the next crisis could involve or even start in developing countries; e.g., analysts note the large inflow of foreign funds into Latin American real estate, where prices have been rising rapidly and an unsustainable bubble may be forming. When a speculative bubble bursts, funds flow quickly across borders and exchange rates swing wildly.

- The global misallocation of financial resources has become huge and persisting, as the United States continues to absorb foreign financial resources on a massive scale. As part of this, developing countries continue to make large net resource transfers abroad. This reflects, in part, the attraction to foreign investors of US Government securities, whose supply has been vastly increased by the US Treasury to finance the very large US budget deficit. Although the US balance-of-payments and fiscal deficits are both widely considered unsustainable and despite market signals to this effect from the fall in the exchange rate of the dollar against other major currencies, there seems to be little international capacity to correct the global imbalance. **Efforts are thus needed to bring about more effective coordination of macroeconomic policies of the world's major**

[3] US Banks now typically sell the mortgages they arrange and use the cash to extend more mortgages, while the buyers of the mortgages use the mortgage interest payments to cover interest obligations on securities they sell to financial investors. The rating agencies assess these securities and appear to have underestimated the risk in the underlying mortgages, which may have misled investors, including hedge funds and other institutional investors, both in the United States and other countries. As it became clear that many US households might have to default on their mortgages, confidence in mortgage backed securities plummeted, and thus so did their prices in the securities markets, collapsing a number of speculative hedge funds, as fear spread to other securities markets. Moreover, as banks usually guarantee the issuers of various types of securities, they would have to lend directly to them if the securities could not be sold in the market, which made them extremely cautious in their other lending.

**economies in the interest of global stability and the growth of wellbeing around the world.**

- Developing countries in a position to do so have built up huge levels of foreign exchange reserves that would have been deemed wildly excessive in the past. Several countries have also prepaid their loans from IMF and the World Bank. Although some of the resources in the growing stocks of reserves are now being redirected into investment funds, the felt need to maintain very high reserves imposes a high cost on the countries. Reserve accumulation, which translates into large-scale purchases of US Treasury securities, thus helping to finance the US budget deficit, is a relatively unproductive use of financial resources that might have otherwise raised the level of capital formation and growth. **The high reserve levels of developing countries reflect their preference for a form of self-insurance, in effect expressing low confidence in the IMF, the designated multilateral institution for prevention and resolution of balance-of-payments difficulties.** The concerns center on whether IMF would be an effective partner or impose a deflationary rather than pro-growth bias in the policy conditions that it would require in exchange for financial assistance, and recognition of the modest level of resources available to IMF for responding to emergencies relative to the needs of today.

<u>Policy directions to address the problems</u>:

- The IMF is meant to be both an international financial institution and an international forum on financial issues. However, it makes decisions like a bank, albeit one that seems to have chased away most of its clients and has reduced resource mobilization capacity. **Rebuilding confidence in the IMF as a central international financial institution seems to require giving more of a governance role to developing countries, and expanding and in some cases redesigning its lending instruments.**

- **Despite current reform initiatives, broader international space is required for international financial policy discussion among all relevant stakeholders, including from all interested governments of the North and South, the private sector and civil society**, especially as there is much unfinished business on systemic financial issues to address, as outlined in the Monterrey Consensus. For example, it was suggested that such discussions could draw lessons from countercyclical success stories for crisis prevention and resolution or it could convoke appropriate drafting groups to devise new or revised norm-setting codes or other financial architecture reforms; in particular:

    1. **New or reformulated policy discussion mechanisms would help bring about a more internationally coordinated and coherent approach to the standard forms of financial regulations**, which are appropriate to developing as well as developed economies. Possible approaches could include internationalizing limited membership consultative bodies on regulation, like the Basel Committee on Banking Supervision of the Group of 10. In addition, one may consider whether private industry-wide (self-regulating) international bodies are sufficient or whether official oversight bodies are needed.

    2. In the light of continuing international financial vulnerability to instability, **systematic thought needs to be given — as in the international process leading to the Doha Review Conference — to extending the range of financial sector activities that require official oversight.** Then, appropriate mechanisms would also be needed to develop relevant regulations for financial sectors or types of institutions that may be

applied globally. Cases that might be reviewed include whether international rules or standards should be developed for asset-backed securities, hedge funds, private-equity funds, or rating agencies.

3. Among the uncertainties that developing countries and creditors still need to take into account is the absence of a comprehensive and fair international debt workout mechanism (see below). **A more effective and cooperative international approach to sovereign debt workouts would also provide guidance for dealing with vulture fund free-riding on internationally coordinated debt relief.**

## Development Assistance and Debt Relief: Volume, Ownership, Efficient Delivery

The Monterrey Consensus contained specific commitments on international financial and technical cooperation for development and on both preventing and resolving foreign debt crises. In 2007, the situation differs from 2002 and new challenges are arising.

<u>Volume and effectiveness of development assistance</u>:

- Since Monterrey, official development assistance (ODA) rose from 0.2% of donor GNI to 0.33% in 2005, to a total of over $100 billon annually. However, the estimated ODA level for 2006 and the projections to 2010 fall far short of what is needed to achieve the Millennium Development Goals (MDGs). Moreover, the Development Assistance Committee definition of ODA, including debt relief and emergency humanitarian assistance, is too broad. Thus, aid figures exaggerate actual aid flows. **A strong political push for substantial additional resources for development is essential.**

- The major ODA donors have sought to reduce the current high transaction and delivery costs and better coordinate fragmented policies. The Paris Declaration of 2005 was a benchmark agreement in the aid coordination effort that embodies five principle tenets: fostering local ownership of country policies; alignment of donors behind national strategies; harmonization of donor efforts; managing for results to raise the productivity of aid, and mutual accountability of donors and recipients. The Third High Level Forum on Aid Effectiveness 2008 in Accra will review implementation of the Paris Declaration, and its results will be available to the FfD Review Conference. Several concerns have been expressed about this process. One is the perceived tendency to re-introduce as aid conditionality policies that failed to win approval in the World Trade Organization, for example, government procurement. In addition, the 2007 G8 initiative on “aid for trade” is seen as embodying an additional entry point for conditionality. This must be resisted if the goal is local ownership. Another concern is that the donor coordination process may impede innovation by donors and reduce the range of choice of programs by aid recipients. There is value in competition among donors, especially with the entry of new donors, who have not signed on to the Paris Declaration. **Strengthened recipient capacity to evaluate and manage aid is essential to more effectively absorb aid flows, as is further opening this process to the contribution of civil society.**

- **The new Development Cooperation Forum of the Economic and Social Council should become a primary instrument for strengthened aid effectiveness**, as it is a global forum for discussion by *all* donor and recipient governments, with an institutionalized role for civil society participation. This forum should become a regular venue for donor and recipient countries to broaden the discussion of policy coordination and improve the governance structure of aid delivery and management. The forum should address salient concerns, for example, the consequences of aid selectivity and failing to meet the special needs of fragile states. In addition, new donors from middle-income countries are being encouraged to harmonize their actions with those of traditional donors, although the new donors view their efforts in a different context, as part of South-South cooperation. There is also concern that aid and export-credit functions within governments should become better coordinated. In addition, the coherence of trust funds and private donations with national policy priorities need to be looked at. Slow donor movement to budget support also needs to be examined.

- Efforts of the 52 countries now in the so-called "Leading Group" to develop innovative sources for financing development and global public goods, such as combating the HIV/AIDS pandemic and climate change, are most welcomed, even though resources generated so far have been relatively small. The Leading Group at its September meeting in Seoul established a working group on tax cooperation and capital flight. **Additional programs — multi-country or individual country initiatives — should be explored. More countries should join promising initiatives, like the air ticket solidarity levy.**

Efforts to prevent and resolve debt crises:

- Compared to aid flows to the poorest countries, resources liberated through debt cancellation are relatively small. Nevertheless, they are important. The Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) were significant steps to resolving unsustainable debt situations of the poorest countries. Debt service of the 31 "post decision-point" countries is projected to decline to 3% of their export earnings in 2011, compared to 18% pre-HIPC. Also poverty reduction expenditure has increased. However, the MDRI assumes donors will replenish the cancelled debt servicing owed to the International Development Association (IDA), the concessional lending arm of the World Bank, and the regular replenishment of IDA is also due. **IDA needs a replenishment adequate to sustain its financial capacity, especially if it is to contribute significantly to the effort to reach the Millennium Development Goals.**

- The IMF and World Bank's joint debt sustainability framework (DSF) for low-income countries was heavily criticised. DSF contains quantitative indicators of possible debt problems and trigger values for discouraging donors from extending new loans based in part on unreliable governance indicators.[4] In addition, DSF does not pay sufficient attention to how debt-financed investment, as in infrastructure, can unlock an accelerated growth potential. It also gives countries incentives to underreport their debt to avoid exceeding the trigger values. Here, the more generous use of grants would help to solve the problem, but so far donors do not provide enough of them. **The concept of debt sustainability should be re-examined so as to more effectively take into account economic and social development.**

- **The risks in international borrowing — both by low and middle-income developing countries — should be better shared between debtors and creditors.** One proposal

[4] In particular, the World Bank's Country Policy and Institutional Assessment (CPIA), which is important in determining IDA country allocations as well as the debt indicators, has been widely criticized in this way.

would be to redesign repayment terms of official loans in a counter-cyclical way, to reduce payments pressure during recessionary times. Official creditors require payment on fixed schedules at fixed interest rates. It was suggested that the World Bank could instead raise or lower payments in response to changes in the growth of borrower GDP and thereby reduce developing country risk. The Bank could then use its far easier access to international financial markets to reduce its own risk. Another proposal is to shorten the standard fixed World Bank grace period on repaying loans with the option to postpone repayments as needed for up to the remaining years of the grace period.

- There is a concern that HIPCs that benefited from deep debt relief would return to debt difficulties from borrowing from new sources, including private creditors and middle-income countries. For example, the burden depends on the exchange rate *vis-à-vis* the creditor at the time of repayment. This underlines the urgent need for capacity building for better debt management in post-HIPCs and other developing countries. The G8 Summit released an Africa Action Plan for good governance and encouraging good borrowing and lending. **This emphasizes the need for better coordination and responsible lending of all official lenders.**

- Creation of an international debt workout mechanism is warranted as much today as it was in 2002 (Monterrey Consensus, para 60; and 2005 Summit Outcome Document). Collective Action Clauses and The Principles for Stable Capital Flows and Fair Debt Restructuring (a code of conduct largely developed by the private sector) are steps in the right direction, but not sufficient to bring about effective and fair debt restructuring. **New efforts should therefore be put into the design of a credible international mechanism for debt crisis workouts that would bring different classes of creditors together for timely and effective debt restructuring with fair burden sharing.** Among other issues, such a mechanism could address the problem of vulture funds, which sue low-income countries in creditor country courts for full debt repayment after other creditors give relief.

## Development Strategies for the Mobilization of Domestic Resources

With all the challenges and opportunities of international economic relations, Monterrey was clear that the *sine qua non* for development was domestic: effective governance, adequate fiscal resources spent well, growing domestic savings and investment. Monterrey also recognized that the appropriate role of government would vary from country to country, but that all countries should promote what we now call the “decent work agenda” and “inclusive” financial sector development. While the list of initiatives in the international community to assist developing countries to mobilize and effectively deploy their financial resources can be extended, the overriding imperative remains that developing countries have the “policy space” for planning and carrying out their economic and social development strategies. This involves actions of their own and of their development partners.

The discussion of development strategies for the mobilization of domestic resources focused on the following issues:

- The major share of capital formation in most developing countries is financed by domestic sources and tapping into these sources provides the main leverage for governments to pursue active growth policies. Directing increased savings to productive investment is central to accelerating economic growth. Developing countries that have been most successful in moving towards sustained levels of growth and poverty reduction have been able to increase investment rates considerably and boost domestic savings. The challenge of improving incentives for investment should be looked at in this context. **Each country has the primary responsibility to design and implement national development strategies to set priorities and decide on an appropriate sequence of government actions for the mobilization of domestic resources**.

- Changes in the international environment can have a major influence on national development strategies, as they affect for example the ability of governments to follow the degree of openness of their economies that is appropriate at the different stages of development. It was acknowledged that the post-war era was characterized by the general acceptance of "Special and Differential Treatment" of developing countries in international negotiations on liberalizing trade. More recent international trade agreements have called that principle into question. Moreover, recent bilateral and regional trade arrangements of developing countries with developed countries have entailed restrictions on the policy choices of developing countries in particular with respect to capital controls and the property rights regime as conditions for increased trade access to partner markets. **The Doha Conference on Financing for Development should therefore revisit the importance of "Special and Differential Treatment" in trade and financial policies for development.**

- Adequate tax revenue is essential for governments to carry out their necessary functions. However, the tax base in developing countries is typically too narrow. It has also been greatly undermined by a race to the bottom in order to attract foreign investors. The economic costs were high as well of tax evasion and loopholes in national tax systems that have made it possible for individuals and enterprises to legally avoid paying their fare share of taxes, as by investing in "tax havens." It seems therefore counterproductive to think about poverty reduction, if at the same time little is being done to help to rebuild developing countries' taxation capabilities, both of their own residents and on foreign-owned capital. Strengthening international cooperation on taxation would not only be an important step for increasing fiscal space for the public sector, but also for enhancing the capacity to use taxes as a redistributive instrument in developing countries. **International tax cooperation for development would be advanced if the UN Committee of Experts on Tax Matters were upgraded to an intergovernmental body, where it could reach stronger international agreements.**

- Revenues from the exploitation of natural resources, in the form of taxes, royalties, signature bonuses and other payments are an important source for the mobilization of domestic resources. However, the lack of accountability and transparency in these revenues can exacerbate poor governance, conflict and poverty. **International cooperation in this area in the run-up to the FfD conference in Doha should draw upon the Extractive Industries Transparency Initiative (EITI).** Moreover, the fight against corruption and the need to recover financial assets illicitly removed from developing countries can make important contributions to public financial resources. **In this regard, the new UN and World Bank Stolen Asset Recovery (StAR) Initiative should be fully supported.**

- The Monterrey Consensus recognizes the role of macroeconomic policy to achieve high levels of employment (section II.A, para. 14) in order to ensure that the benefits of growth reach all people. Recent economic growth in developing countries has not only been accompanied by increased inequality, but also failed to provide adequate improvements in employment. At the macroeconomic policy level, attention needs to be focused on the effects of economic growth on employment generation and productivity growth. Over the last few decades, monetary and fiscal policies in many countries have shifted towards achieving and maintaining low levels of inflation. This has often led to pro-cyclical adjustment of economies which has been detrimental to long-term growth and thus to employment creation. **Countries need to create more capacity and space to conduct counter-cyclical macroeconomic policies. In order to foster the realization of decent work for all, governments have to ensure adequate levels of public expenditures over the medium term in the areas of infrastructure, social safety-net systems and human capital development.**

- The reach of formal financial services is limited to a small proportion of the population in developing countries. Typically, it is the poor who have no or a very limited access to the financial system, which has become a matter of wider development-related concern. Microfinance has grown rapidly, but still reaches only a small number of potential beneficiaries. In order to enable the poor to start micro- and small enterprises they need access to lending, as the necessary spending on working capital and fixed investment usually exceeds their access to resources. The poor also want and will use access to financial services on appropriate terms, including savings, insurance and payments, particularly remittances. **Therefore, there is a need for a much more inclusive and broad-based approach to provision of financial services for all segments in the population.** Such an approach should also include the strengthening of access to finance for small and medium- sized enterprises, such as by encouraging the creation of venture capital funds and support by international and national development banks.

## The Way Forward

There is a concern that the spirit that drove the original Monterrey process has dissipated, and that it is necessary to rebuild trust among the participants as they work towards the Doha meeting. Participants should not hesitate to innovate in how they interact. In this regard, identifying issues that are ripe for agreement can help raise the tone of discussions and catalyze additional consensus building. If the international community can recapture the spirit of Monterrey, it can open the way for new "dreams, decisions, and deeds."

<u>The Way to Doha</u>

- **Steps in preparing the Doha meeting should make use of the essence of the Monterrey process, which is to focus on substantive discussion in informal formats.** This could include intensive and short-duration multi-stakeholder working groups on specific high priority issues. In addition the UN and other institutional stakeholders should organize regional meetings on salient issues. These discussions could enrich informal substantive discussions at global political level. The objective would be to use the preparatory process to build momentum around appropriate actions; and minimize dispiriting review negotiations over competing texts.

- FES and other organizations are encouraged to organize unofficial brainstorming meetings to provide a space for in-depth discussions on the substantive issues. Such meetings could clarify proposals on specific issues, introduce new proposals and, in general, help stakeholders prepare their participation in the Follow-up Conference in Doha.

The Doha Conference and Beyond

The Follow-up International Conference on Financing for Development in Doha in 2008 could consider lessons from best practices and new initiatives that build on the Monterrey Consensus. The official outcome document should at the same time review the implementation as well as address new challenges and emerging issues.

A disappointment after the Monterrey Summit was the weak process for engaging all relevant stakeholders in monitoring implementation. Two instruments have been used to review and foster further implementation of the commitments made in Monterrey, but they have largely performed as isolated discussions without follow-up. One is the ECOSOC Dialogue with the key international financial and trade institutions, which takes place one day every year. The other is the High-level Dialogue on Financing for Development of the General Assembly, which takes place over 2 days every 2 years. **There is a clear need for a more systematic, continuous and strengthened follow-up process, and thus a more institutionalised mechanism. One proposal is to create a new UN Committee on Financing for Development.**