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Responses to the Challenges of Globalisation

A Study on the International Monetary and Financial System and on Financing for Development

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EXECUTIVE SUMMARY[1]

This report responds to a request by Finance Ministers to the Commission on 16 October for a study on the Responses to the Challenges of Globalisation. In line with the terms of reference, the Commission has focused on two main issues: the discussion on the reform of the international monetary and financial architecture as a response to global financial crises and the issue of financing and promoting development as a means to reduce global inequality. While the report reviews some of the economic facts and features of the current globalisation process, it does not focus upon many other important aspects of globalisation in the fields of social policy, health and environment. These topics are addressed in the Commission's Communication "Towards a Global Partnership for Sustainable Development", which sets the parameters for a comprehensive and balanced approach by the EU towards a global deal.

Given the limited time available and the broad scope of the terms of reference, the report does not include original research, but builds on existing literature. It attempts to reflect some of the ongoing debate among academics, policy makers and non-governmental groups as input for a policy discussion at Commission and Council level.

Globalisation: Where Do We Stand?

Globalisation is a process that has been ongoing, albeit not in a linear fashion, over a long period. Post-war globalisation has many facets. In the economic and financial sphere, which is the subject of this Communication, it has been characterised by a strong expansion of trade in goods and services and, more recently, by a strong expansion in capital flows. Several factors are underlying this growth process including technological progress, leading to dramatic reductions in transportation costs and an unprecedented increase in information processing capabilities, and public policy measures, such as a lowering of quantitative and tariff restrictions on trade and the liberalisation of capital movements.

The process of globalisation over the past fifty years has been accompanied by a six-fold rise in world output while the global population increased about two and a half times. This translates into major improvements in the income of a substantial part of the world's citizens and into increased resources with which to tackle policy challenges. The past fifty years have further witnessed major improvements in other indicators of human welfare and quality of life in a large number of countries, including significant improvements in life expectancies at birth.

Although correlation does not imply causality, there is little doubt that the substantial increases in global per capita income that have been achieved would not have been possible without continued progress towards deeper economic integration. Recent studies from the World Bank confirm that developing countries that have opened up their economies over the last twenty years have had a growth performance superior to those that have not pursued international economic integration.

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1. This executive summary is based on the Communication of the Commission to the Council, the Parliament, the Economic and Social Committee and the Comite of the regions on 'Responses to the Challenges of Globalisation: A Study on the International Monetary and Financial System'.

However, despite the overall increase in income and welfare, the gap between richer and poorer countries and between richer and poorer segments of the population within countries has probably widened. In particular, it should be recognised that while globalisation is likely to benefit overall those countries that are able to participate in it, it does create problems for certain categories of the population. An example of this is the mixture of reduced relative wages and employment opportunities that have affected low-skilled workers in industrialised countries. Public policies have an important role to play in tackling the difficulties faced by those that may lose from globalisation, while ensuring that those countries that integrate into the global economy are able to reap the overall benefits.

There also remains a group of, mostly very poor, countries that are less integrated into the global economy and that continue to be largely excluded from the benefits of the globalisation process. South Asia and Sub-Saharan Africa lag far behind regions such as East Asia and the Pacific. Their share in world trade has fallen, their terms of trade have deteriorated and they continue to be unable to attract foreign capital. Improving living standards and the economic situation in these countries is one of the major challenges for the global economy.

In addition, globalisation is associated with other challenges such as communicable diseases, climate change, loss of biodiversity or lack of international security. Addressing these issues - that is, providing the world with global public goods - can be seen as part of a strategy aiming at maximising the benefits of globalisation and minimising its negative effects. These global public goods benefit developing and industrial countries alike. They are an additional task to poverty reduction and their financing should be explored.

The increased internationalisation of economic activity that globalisation has brought raises issues about the appropriate level of economic policy-making and the capacity of national governments to set rules and standards. In this context, the report notes that over the course of the 20th century, the role of the state in economic activity has increased significantly in many developed countries. This has been partly due to the post-war development of social safety nets and welfare systems that are seen to play an important risk-reducing role in societies that are exposed to international competition.

The report also highlights the fact that since the end of the Second World War, major progress was made in establishing a set of international and regional institutions and fora that provide international economic and financial governance. The current institutional arrangements are seen to constitute a more robust set of institutions and fora to deal with global policy challenges than existed during previous waves of globalisation. However, new emerging challenges point to a number of inadequacies in the system, and reform proposals concerning various aspects of this governance system are currently discussed.

The International Monetary and Financial System in a Globalised World

The Commission study looks in more detail into the evolution and the functioning of the international monetary and financial system and finds that, overall, the system has functioned well over the past half century. It has complemented the strong growth in trade of goods and services by channelling savings into productive investment world-wide through open and well-functioning financial markets and by providing efficient clearing and settlement systems. It has thereby contributed to global economic growth and has allowed countries embracing sound policies to raise the living standards of their population. The system has also been able

to cope with periods of disequilibria in balance-of-payments and has ensured monetary stability in times of financial stress.

Nevertheless, recent experiences have brought to the fore a number of real or potential systemic weaknesses, posing new challenges to policymakers. Although the integration of financial markets and the institutional and regulatory frameworks in which they operate have spurred economic growth, the international monetary and financial system has continued to be crisis-prone. With the exception of the ERM crisis of 1993, the crises of the nineties have mainly affected emerging market economies and, for most of them, have had important consequences in terms of output loss, welfare, social conditions and unemployment. In addition, the changed international financial environment has been seen as allowing abuses in terms of money laundering, financing of illegal activities and tax evasion.

Recent years have seen the emergence of numerous proposals on how best to adapt the international monetary and financial system to the changes and challenges of a global economy. The report reviews the current policy debate and provides a short analysis of the pros and cons of the main reform proposals, their political and practical feasibility as well as an assessment of the necessary conditions for success. The reform proposals have been grouped into four categories: modalities of crisis prevention and management, initiatives to reduce the abuses of the international financial system, regional and global co-operation, and reform of the institutional framework.

Modalities of Crisis Prevention and Management

The proposed solutions are numerous: they range from very modest ones, such as increasing and improving the flow of information to market participants, to very ambitious ones such as the creation of a single world currency. Some initiatives are in the process of being implemented, reflecting a high degree of consensus among the international financial community; others lack at present sufficient political support or would imply a too high level of public interference in the markets. Whereas most of the proposed changes could be dealt with within the existing framework, some of the more ambitious ones would require the creation of a new institution or a much more profound reform of the international financial architecture.

At the crisis prevention level, suggestions for further progress that are broadly accepted include increasing transparency in policy design and implementation, and improving the flow of information to market participants; developing and deepening financial markets and strengthening domestic financial systems to make countries less vulnerable to crises; and strengthening the foreign exchange reserves of emerging market economies. Their implementation by many countries is already contributing to making the system more predictable and more resilient to shocks.

Progress is also being made on other fronts but at a slower pace because these proposals are either of a less consensual nature or more difficult to implement in practice. These proposals include the development of early warning systems; the introduction of collective action clauses into new international bond issues of emerging market economies; the creation of Clubs of Creditors; the development and use by emerging market economies of financing instruments that can be used as a first line of defence in case of crisis; and the need to ensure an orderly and well-sequenced capital account liberalisation process.

Finally, there are a number of proposals that have yet to gather sufficient support by policymakers and which often require important institutional changes, the merits of which need to be carefully weighed. Establishing an international debt insurance agency, creating an international prudential supervisory agency or introducing a currency transactions tax are among the more visible proposals.

While not claiming to be exhaustive, the report pays particular attention to the use of a currency transaction tax as a tool to stabilise exchange markets. Proponents of a tax on international currency transactions argue that it would contribute to exchange rate stability by reducing arbitrage and speculation. The literature, however, suggests that the tax may actually increase volatility, as trading volumes are likely to fall significantly following its introduction.

At the crisis resolution level, a topic high on the international agenda is to find the proper balance between adjustment by the debtor country, official financing, and private financing. This balancing exercise has become much more complex than 20 years ago. The question also arises whether, and to what extent, the balance should be tailored to specific country circumstances. This highlights the importance of making further progress in clarifying and developing further the principles for private sector involvement in both the prevention and the resolution of financial crises. The international community has also recently recognised the need to analyse how a clearer and more solid legal framework for debt standstill, debt restructuring, and debt reduction could contribute to facilitate orderly crisis resolution. Here too, some proposals imply more significant institutional changes.

Reducing the Abuses of the International Financial System

The use of the international financial system for illicit purposes has become a major concern. Characterised by a high degree of openness and decentralisation, the system is being used for criminal activities, including money laundering and the financing of terrorism, for tax evasion and for the circumvention of regulations. In some cases, corporate entities are deliberately created for such purposes. The abuse problem is compounded by the existence of a number of countries and judicial territories that see their comparative advantage in granting favourable tax and regulatory environments for non-residents funds. Financial abuses can threaten the credibility and undermine the integrity of the international financial system and affect countries at every stage of development.

In response to these challenges international collaboration has been intensified through existing fora and organisations, such as the G7 Finance Ministers, OECD work on harmful tax practices and the Financial Action Task Force on money laundering and on the financing of terrorism. The Financial Stability Forum established in 1999 has worked on a variety of questions, including the activities of highly leveraged institutions and offshore financial centres. Specific actions have been taken against terrorist financing. In line with UN Security Council Resolutions, assets of targeted persons and organisations associated with the Taliban have been frozen. Increased corporate transparency and better integrated supervisory systems are seen as necessary conditions to prevent the misuse of corporate vehicles for illicit purposes.

A common challenge to most of the proposals reviewed is the question of how to ensure compliance of non-signatory third partners. It is sometimes argued that better compliance with international rules and practices could result from improved co-ordination between the

existing institutions engaged in related projects. Furthermore, the fight against unfair practices has to be placed in the broader context of a coherent and sustainable approach to development.

Regional and Global Co-operation

The study also reviews initiatives to enhance the stability of the international monetary system through intensified macro-economic co-ordination within the context of regional groupings and among the three major currency areas (G3). Regional macroeconomic and monetary co-operation are frequently seen as a way of strengthening economic integration, growth and stability. The introduction of the euro provides an example of successful regional integration that has not only been beneficial for Europe but also is likely to contribute to the stability of the international monetary and financial system. Although the European experience cannot be translated directly, it provides an example to other regions of the world. While Asian economies have made progress in enhancing financial and monetary co-operation in the region, monetary co-operation policy has, so far, played no or only a negligible role in the design of regional economic integration schemes in the Americas. This raises questions about the compatibility of different exchange rate systems with the objective of regional integration.

Against the background of growing economic and financial interdependence, and the potential for more sudden and deeper spill-overs of shocks between the three major currency areas, a number of proposals advocate some kind of exchange rate co-ordination between the G3. Proponents argue that the targeting of exchange rates among the G3 currencies would increase the overall stability of the international monetary and finance system, implying fewer crises and higher growth for both the major currency areas as well as for emerging economies and developing countries. Others claim that this would imply that monetary policy authorities would lose to a significant degree the ability to react independently to external shocks and domestic policy priorities.

Towards Improved Governance of the International Monetary and Financial System

Discussions on improving the governance of the international monetary and financial system often focus on the International Monetary Fund (IMF), where significant decision making power related to the international monetary and financial system is vested. Over the past fifty years, the institution has been able to accommodate a substantial increase in both its membership, thereby becoming a quasi-universal institution, and in the scope of its mandate. Recently, however, there have been calls from emerging market economies, NGOs and national parliaments for more legitimacy, more accountability, and better governance for the Fund. Progress has been made to address these concerns, including through increased transparency of the IMF decision process; through the creation, outside the IMF, of groups such as the Financial Stability Forum and the G20; and through the transformation of the Fund's Interim Committee into a more permanent International Monetary and Financial Committee. However, proposals with a greater institutional content, such as transforming the International Monetary and Financial Committee into a Council with decision power and re-balancing the decision power within the Fund have made little progress or are still under review.

The report also reviews proposals to create new overarching bodies, such as a Global Governance Group or a UN Economic Security Council. Such initiatives would require widespread political support to be initiated.

Promoting and Financing Development

A number of poor countries have been largely unable to participate in the benefits of globalisation. They are trapped in a situation of low income and poverty, low levels of education and investment and sometimes high indebtedness. For these countries, international assistance is crucial. The report reviews four existing development instruments: official development assistance; debt relief; trade measures; and promotion of foreign direct investment. In addition, the report discusses some alternative sources of financing for development, including proposals for international taxes.

Official Development Assistance

Overall, trends in official development assistance (ODA) have been disappointing. Official development assistance by major donors in terms of their GNP declined from 0.33% in 1990 to 0.22% in 2000 (0.33% for the EC) and thus further away from the aid target of 0.7% originally put forward by the 1969 Pearson Report. The measurement of ODA has also been criticised for over-estimating the true level of ODA relative to that which would have been recorded had the original definition been strictly applied. The World Bank has recently estimated that current levels of ODA would need to be doubled in order to help low-income countries to reach their millennium development goals of halving poverty between 1990 and 2015.

In addition to concerns related to the level of ODA, there is a need to ensure an effective use of existing ODA resources. The debate on the effectiveness and quality of aid has led to the identification of a number of important elements, such as prioritisation, co-ordination, conditionality and ownership of policies, policy coherence and untying of aid, which are increasingly being taken into account by the EU and other major bilateral and multilateral donors.

One example is the debate on conditionality and ownership, which is related to the observation that economic reforms can be supported but “cannot be bought”. This implies that conditionality on adjustment lending will stimulate reforms better if they are in line with the government’s own programme. As a result, bilateral and multilateral donors now emphasise partnerships among governments, development co-operation agencies, civil society, and the private sector, in order to stress country ownership of the process. There is also a tendency towards refocusing aid towards “good policy - high poverty” countries, where the effectiveness of aid is seen to be highest.

The effectiveness debate also focuses on the requirement by some donor countries that the recipient country sources public procurement from companies in the donor country. OECD studies demonstrate that tied aid increases the cost to recipient countries of many goods and services by between 15 and 30%. There are therefore strong arguments in favour of “untying” aid, which were given new momentum when, in May 2001, donors agreed on a DAC (Development Assistance Committee) recommendation to untie ODA to the least developed countries as of 1st January 2002.

The fragmentation of aid and poor co-ordination have frequently been a major obstacle to aid effectiveness. The process of recipient country-led poverty reduction strategies should provide common ground for improving donor action at the country level in many of the poorest countries. Within donor countries, the promotion of coherence between development policies and those of trade, security, investment, social policies and the environment continues to be a major challenge.

Debt Relief

The report reviews progress with respect to alleviating the debt burden of developing countries, which saw their debt relative to GNP double between 1981 and 1998, with a slight decline in the following years. After repeated debt relief actions provided by official bilateral and private creditors, the HIPC debt initiative launched in 1996 dealt for the first time with the debt owed to multilateral institutions. The HIPC initiative was enhanced in 1999 to provide deeper, broader and faster debt relief and it is generally recognised that the initiative constitutes an important step in the right direction towards helping poverty reduction.

Apart from the issue of ensuring a rapid implementation of this initiative, there is a continued debate whether this action is sufficient to ensure sustainability and poverty reduction, even though the responsibility of the beneficiary countries in pursuing the right policies remains key to its long-lasting impact. There is also a discussion on whether enough countries are covered by this initiative. For poor countries in conflict, which are in principle eligible, but have not yet qualified, action has been taken by the G7 to reinforce political dialogue. Proposals have also been made to extend the initiative to more countries than the 42 HIPCs, but this comes up against significant financing constraints.

Trade Measures

As several studies reviewed in the report have shown, trade openness is a necessary, albeit not sufficient, condition for economic growth and thereby poverty reduction. Progress in this respect is conditional upon appropriate flanking policies, supported by trade related capacity building and further trade liberalisation by all countries, including developing countries themselves.

Although a number of developing countries have become more integrated into the world economy in recent years, they are too often disadvantaged as regards market access. Agricultural and labour-intensive manufactured goods (such as textiles), where developing countries' comparative advantage often lies, frequently face the highest trade barriers in developed and developing country markets, although the impact of such tariff peaks is to some extent offset by preferential access to developed economies. Initiatives such as the EU's 'Everything But Arms' initiative launched in early 2001, help to remove these distortions for least developed countries (LDCs)' exports to the EU. The adoption of such initiatives by other major developed countries, in line with commitments taken at the 3rd UN Conference on LDCs in 2001, could bring further benefits to LDCs.

At the multilateral level, the Doha WTO Ministerial Conference in November 2001 launched an ambitious negotiating agenda of trade liberalisation underpinned by strong and transparent multilateral rules – the Doha Development Agenda – which offers the prospect of significant gains to all WTO members, with a particular focus on the needs of developing countries. At

the regional level, regional trade agreements can provide an important stimulus to integration with the global economy and can reinforce regulatory co-operation, locking in reforms and providing clarity and consistency to potential investors. Such regulatory co-operation should, whenever possible, be based on agreed multilateral norms and attention should be given to potential additional administrative costs for developing countries and the provision of adequate technical assistance.

Promotion of Foreign Direct Investment

In recent years, foreign direct investment (FDI) has received increasing interest from policy-makers due to its growing importance for both developed and developing countries. Flows of direct investment towards developing countries increased seven-fold between 1990 and 2000, although they have been heavily concentrated in a limited number of countries (middle income countries capture 93 percent) and make up for less than one fifth of world flows. FDI can potentially play an important role for economic development and hence poverty reduction through employment creation, technology transfers, productivity increases and enhancement of export capacity. However, according to the studies reviewed, some specific conditions are needed for this potential to be realised. The notion of 'absorptive capacity' arises, as it has been demonstrated that a minimum level of knowledge is necessary to absorb the foreign technology. Similarly, to avoid monopolistic behaviour by powerful multinational firms, appropriate use of competition policies and their effective enforcement can be a useful instrument. Finally, a liberalised trade regime is a complementary tool to maximise efficiency and fully benefit from the potential of FDI to enhance the export capacity of the host country.

As far as active government investment-promotion policies are concerned, their desirability is not entirely clear. FDI is primarily determined by exogenous factors, such as geographical position, market size and availability of natural resources. Beyond these, necessary conditions include economic, political and regulatory fundamentals (such as the rule of law) that ensure a stable environment for foreign investors. These factors are mainly the responsibility of local governments. The main role and challenge for international institutions is to create mechanisms that facilitate FDI more globally. Many also argue that developing countries would benefit from a multilateral framework of rules for investment that would be cost-effective, transparent and stable and ensure non-discrimination.

Alternative Financing Instruments

The report looks into several alternative sources of financing that have been proposed, including international taxes, the De-tax and the allocation of Special Drawing Rights (SDRs). In addition to generating financing for development, international taxes are being discussed as a way to contribute to the provision of global public goods. The taxes discussed in the report are a tax on international currency transaction, a tax on carbon dioxide emissions, a tax on aviation fuel and a tax on arms exports.

All the international tax proposals reviewed in the report follow a dual objective. While they aim to raise revenue as a means of funding development and/or the provision of global public goods, they also have the purpose to motivate changes in behaviour by modifying relative prices and hence to correct international economic distortions and contribute to the provision of global policy objectives, such as financial stability, the protection of the global environment and the prevention of conflict.

While as a source of additional revenue a currency transaction tax may look appealing, its feasibility is, however, not demonstrated. Various proposals have been put forward, but even if applied in the settlement system, issues such as the enforcement of the tax and the preservation of the tax base need to be addressed. To be sustainable, such a tax would most likely require a multilateral approach, including the compliance of the major international financial centres.

An international carbon tax as well as a tax on the consumption of aviation fuel have been discussed as means to internalise the negative environmental effects of carbon dioxide and other types of emissions by increasing the costs of emission. In terms of potential revenue, a global carbon dioxide tax might be the most promising; at international level, however, the political momentum has shifted to non-tax economic instruments such as emissions trading.

There is general acceptance that the international proliferation of arms has significant negative implications for international security and the taxation of trade in arms has been suggested as a way to curb this trade. While in principle the taxable base (production or trade) can be defined, there are various challenges and obstacles in practice. These include the lack of transparency in international arms trading and the voluntary nature of the existing international frameworks. Taking into account the data uncertainties characteristic of the international arms market, the revenue potential of a tax on arms trading is expected to be limited.

International taxes need to be administered. Collection at national level will require a very high degree of co-ordination among countries, while establishing a new international body raises a lot of additional issues, including those related to democratic control and transparency.

While more work needs to be done to validate these provisional conclusions on international taxes, it seems that meeting needs for enhanced financing of development and for the provision of global public goods in the short- to medium term will require more substantial contributions from national budgets and a further increase in the efficiency of resource use than is presently the case.

Proposed as an alternative to compulsory financing through taxation, the “1% De-tax” scheme advocated by the Italian government builds on voluntary consumer and vendor decisions to earmark one percent of the purchase at retail level to an international development project. The government would exempt this contribution (“de-tax”) from VAT and company income tax. While this source of enhanced voluntary contributions lacks the predictability of tax-based revenues, it has the advantage that it can be introduced unilaterally.

An SDR allocation (a selective one targeted at the poor countries or a general one whereby industrialised countries pool their new SDRs for use by developing countries) has also been proposed as a way to provide additional financing for development purposes. Ultimately, however, SDRs are not a free lunch. They constitute a right of a country to obtain a short-term credit with another country, the one that it buys currency from, at a specified interest rate. Conceived in the sixties as a tool to supplement a perceived shortage of international liquidity at world level, using an SDR allocation as a way to provide unconcessional long-term credit to developing countries does not seem to be a suitable approach.

LIST OF ABBREVIATIONS

ACP – African, Caribbean and Pacific countries

ADB – Asian Development Bank

ALA – Asian and Latin American developing countries

ASEAN - Association of South-East Asian Nations

ATW – Air Transport World

BAD –Banque Africaine de Développement

BIS – Bank for International Settlements

BITs – Bilateral Investment Treaties

CAC – Collective Action Clauses

CAEMC – Central African Economic and Monetary Community

CCL – Contingent Credit Line

CDF – Comprehensive Development Framework

CEEC – Central and Eastern European Countries

CIS – Commonwealth of Independent States

CMEA – Council for Mutual Economic Assistance

CTT – Currency Transactions Tax

DAC – Development Assistance Committee

DDA – Doha Development Agenda

DQRS – Data Quality Reference Sites

ESAF – Enhanced Structural Adjustment Facility

EBA – Everything but Arms (EU trade policy initiative)

EEA – European Economic Area

EBRD – European Bank for Reconstruction and Development

EIB – European Investment Bank

ESC – UN Economic Security Council

EU – European Union

FATF – Financial Action Task Force on Money Laundering

FDI – Foreign Direct Investment

FIAS – Foreign Investment Advisory Service

FSAP – Financial Sector Assessment Program

FSF – Financial Stability Forum

FSSA – Financial System Stability Assessment

G7– Group of Seven leading industrialised nations (Canada, France, Germany, Italy, Japan, United Kingdom, United States)

G8 – G7 plus Russia

G20 – Group of Twenty

GATT – General Agreement on Tariffs and Trade

GDDS – General Data Dissemination System

GDP – Gross Domestic Product

GFCF – Gross Fixed Capital Formation

GNP – Gross National Product

GSP – Generalised System of Preferences

HIPC –Heavily Indebted Poor Country

HLI – Highly Leveraged Institution

IBRD – International Bank for Reconstruction and Development

ICAO – International Civil Aviation Organisation

ICT – Information and Communication Technologies

IDA – International Development Association

IDB – Inter-American Development Bank

IFMS – International Financial and Monetary System

ILO – International Labour Organisation

IMF – International Monetary Fund

IPCC – Intergovernmental Panel on Climate Change

ITO – International Tax Organisation

LDC – Least Developed Country

LIC – Low Income Countries

LOLR – Lender of Last Resort

LTCM – Long Term Capital Management

ODA – Official Development Assistance

OECD – Organisation for Economic Co-operation and Development

OTC – Over-the-Counter

MAI – Multilateral Agreement on Investment

MEDA – Euro-Mediterranean Partnership

MFN – Most Favoured Nation

MIGA – Multilateral Investment Guarantee Agency

MNE – Multi-National Enterprise

NAFTA - North American Free Trade Agreement

NPV – Net Present Value

PIN – Public Information Notice

PRGF – Poverty Reduction and Growth Facility

PRSC – Poverty Reduction Strategy Credit

PRSP – Poverty Reduction Strategy Papers

PSI – Private Sector Involvement

RTA – Regional Trading Agreement

SDDS – Special Data Dissemination Standards

SDR - Special Drawing Right

SPS – Sanitary and Phytosanitary Measures

STABEX – System to Stabilise Export Earnings

SYSMIN - System for Safeguarding and Developing Mineral Production

TBT – Technical Barriers to Trade

WAEMU – West African Economic and Monetary Union

UN – United Nations

UNCTAD – United Nations Conference on Trade and Development

UNDP – United Nations Development Programme

UNFCCC – United Nations Framework Convention on Climate Change

US – United States of America

VAT – Value Added Tax

WB – World Bank

WEO – World Economic Outlook

WTO – World Trade Organisation

Responses to the Challenges of Globalisation

A Study on the International Monetary and Financial System and on Financing for Development

CHAPTER I: GLOBALISATION: WHERE DO WE STAND?

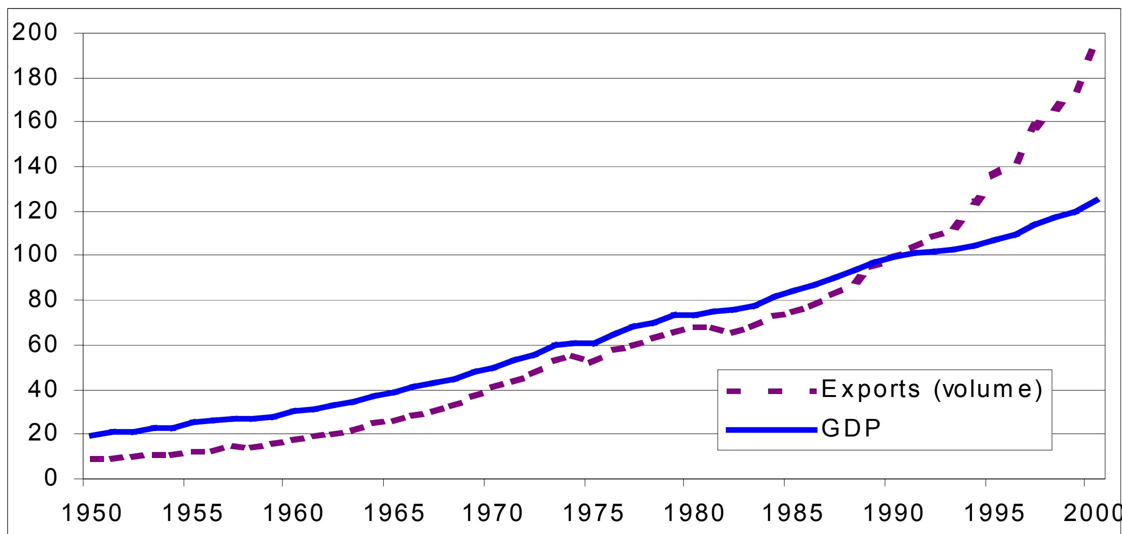
Globalisation can be characterised as a trend towards greater integration and interdependence between countries and regions of the globe. These growing linkages are often economic and political, but globalisation also has important social, environmental and cultural aspects. This introductory chapter focuses upon the economic aspects of globalisation, by looking at trends in international flows of goods and services, capital and labour (section A) and seeking to identify some of the driving forces (section B). It highlights the benefits that accrue to countries and regions that integrate successfully with the global economy (section C), but also identifies some of the limitations of current globalisation and the important public policy challenges that remain (section D).

A. Current Globalisation Trends

This section of the chapter describes trends in international flows of economic factors of production: goods and services, capital and labour.

Trade in Goods and Services

Figure 1: Trends in World Trade in Goods (volume) vs. GDP (1990 = 100)



Source: Commission services based on WTO (2001)

When examining the economic interdependence of the globe, one obvious approach is to look at trade flows. Figure 1 compares the post-war evolution of world trade volumes in goods compared to world real GDP. A six-fold increase in global output has been accompanied by a

20-fold expansion of global merchandise trade flows[2]. Merchandise trade growth was particularly strong during the 1990s. World trade in services also grew at a fast rate through the 1990s: more than doubling from 530bn ECU/ euro to 1194bn euro[3] between 1992 and 2000. Whilst some services are inherently difficult to trade (the classic example being a haircut), more and more services are becoming tradable[4].

The composition of trade in goods and services has also evolved over time. Rich countries increasingly trade similar, but differentiated, goods and services between themselves (intra-industry trade). Multinational firms now play an important role in the global economy and are frequently able to slice their production chain internationally, thus contributing to the estimate that roughly 30 per cent of world trade in manufactures is in intermediate rather than final goods (Yeats, 1998). Developing countries are playing an increasingly significant role in manufactures trade. The World Bank (2002) reports that the share of manufactures in developing country exports rose from 25% in 1980 to 80% in 1998. Increasing amounts of trade now flow between developing countries[5], but the poorest countries continue to play only a marginal role in international trade[6]. Some countries, in particular those of Sub-Saharan Africa, have seen their share in world trade drop during the last two decades and have experienced a deterioration of their terms of trade.

International Flows of Capital

The extent of international flows of capital and of the information needed to make investment decisions can provide further evidence of international economic interdependence. Today, gross flows of short-term capital in particular are huge by long-term historical standards. The latest Bank of International Settlements data report average daily foreign exchange market turnover at US$ 1210bn in April 2001. This is roughly double the figure for 1989, but a decline of 19% on 1998[7]. Daily turnover in over-the-counter derivatives, such as swaps and options, reached US$ 575bn in April 2001, compared to US$ 151bn in 1995 and US$ 265bn in 1998. A report by the Ministry of Finance, Finland (2001) notes[8] that gross direct investments by industrial countries rose steadily between 1993 and 1998, from US$ 212bn to US$ 585bn per year. The financial information that underpins investment decisions flows around the globe to investors who possess the appropriate technology almost instantaneously and in huge volumes nowadays. International capital now also flows into a wider range of economic activities than previously (CEPR, 2001). Late 19th century international capital flows, for example, were heavily focused upon infrastructure construction projects, such as railways.

There remains, however, a debate about the true extent of current global capital market integration relative to previous historical periods. Bordo et al (1999) argue that a combination of slower technology for transferring funds, information asymmetries, legal uncertainties, and the absence of adequate accounting standards limited the true extent of financial market

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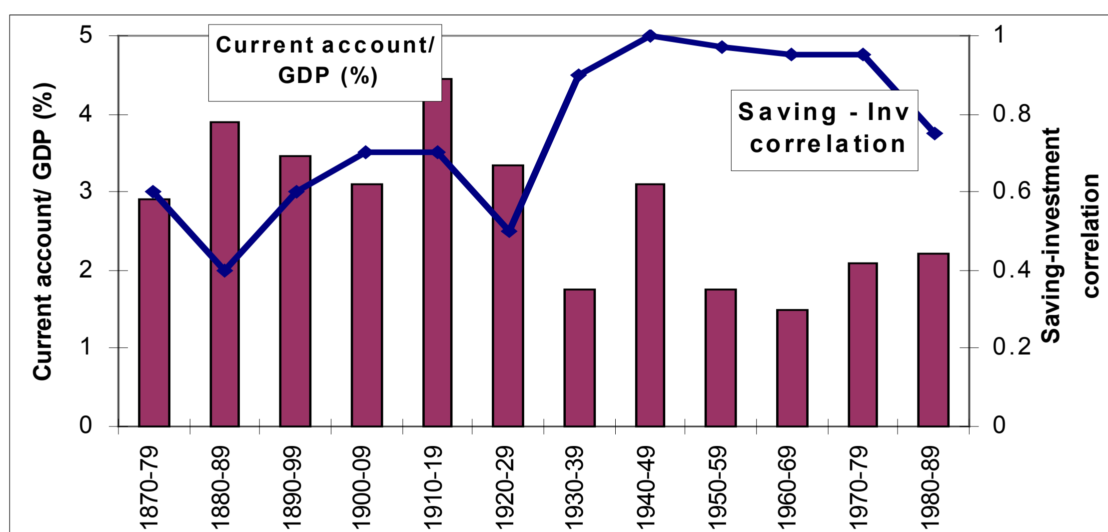
2 There is a sizeable literature that argues that increased trade leads to higher economic growth , e.g. Frankel and Romer (1999).
3 Eurostat news release 117/2001 (2001). Note that this data excludes intra-EU trade.
4 The dynamic growth of trade in services is boosted by growth in FDI, discussed later in the section.
5 IMF and World Bank Staff (April 2001).
6 For example, WTO (2001) reports that in 2000 the merchandise exports of Africa, excluding South Africa, were US$ 115bn, compared to EU exports of some US$ 2251bn.
7 Daily turnover in 1998 was US$ 1490bn. The BIS cites the launch of the euro, the growing importance of electronic broking, and banking consolidation as likely factors for the decrease in 2001.
8 Based on IMF (1999).

integration in the late 19th century. In general, these imperfections are less significant today, but persist to some degree.

One way of assessing the degree of international capital market integration is to look at the absolute size of the current account relative to GDP. This is equivalent to the net capital in- or outflow, and thus provides a simple, if somewhat crude, indication of capital market integration[9]. Another indicator of international capital mobility is the correlation between domestic saving and domestic investment. In a world of perfect capital mobility, there should exist no systematic relationship between domestic saving and domestic investment[10], since the savings of residents in any given country should be allocated to the investment project yielding the highest return, wherever it is geographically located.

Figure 2: Correlation Between Domestic Saving and Domestic Investment, and Current Account as a % of GDP for 12 Major Countries



Source: Commission services based on Baldwin and Martin (1999)

Figure 2 presents these two indicators averaged across 12 major countries[11] for the period 1870 to 1989. The current account data (the unweighted mean absolute average relative to GDP) show that larger proportional net flows of capital were occurring at the beginning of the 20th century than during the 1980s. According to the data on domestic savings/domestic investment correlation, international capital market integration was only beginning in the 1980s to get back to the level of the late nineteenth century. However, the data-set contains only a limited group of countries and there remains much debate about the appropriate methodology for assessing and comparing international capital mobility[12].

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[9] Note that a country which both exports and imports large amounts of capital could still record an absolute current account balance of zero, if the debits and credits match and thus "cancel out". More generally, it is important to underline that, because of these compensatory flows, net capital flows, as commonly used, give a vision of financial integration which is heavily underestimated. This is particularly visible in the case of short-term capital flows between affiliated companies, which are part of FDI and have reached very high levels, but don't generally appear in net flows, although recent trends to centralise financial departments in multinational companies have made them more visible.

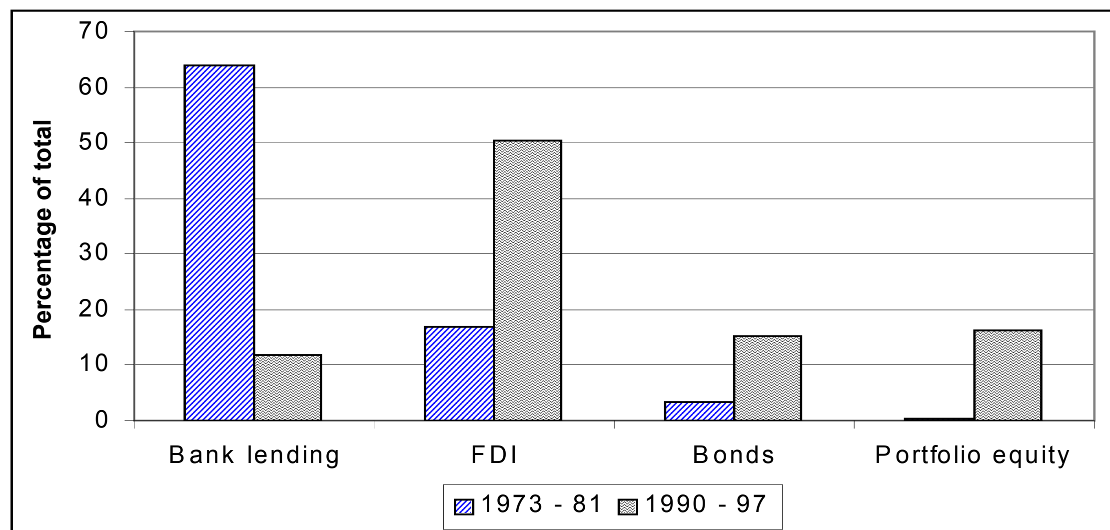
[10] This idea is often referred to as the Feldstein-Horioka puzzle after a 1980 paper that examined it.

[11] Argentina, Australia, Canada, Denmark, France, Germany, Italy, Japan, Norway, Sweden, UK, US.

[12] Taylor (1996) discusses some of these issues.

The structure of the capital flows described above has been evolving over time. In the Gold Standard era up until World War I, bonds were the dominant means of raising long-term capital. After the collapse of the Bretton Woods system in the early 1970s, syndicated bank lending became the dominant instrument. The position changed again in the 1990s as foreign-direct investment (FDI) grew markedly in importance, with equity finance, bonds and bank lending also playing a role (figure 3). Financial crises featured in all of these periods[13].

Figure 3: Composition of Private Capital Flows (1973-81, 1990-97)



Source: World Bank, Global Development Finance (2000)

Crafts (2000) highlights the growing importance of FDI and points out that multinational enterprises nowadays play an increasingly important role in the global economy. UNCTAD numbers multinationals in the tens of thousands today, compared to only a few hundred at the end of the 19th century. Craft notes that the value of the US FDI stock in 1996 stood at around 20% of GNP; compared to roughly 7% in 1914. More generally, it is estimated that production by overseas facilities of multinationals represents a sixth of global industrial production.

A recent study by Venables et al. (2001) for the European Commission also emphasises that FDI flows may link economies more strongly than trade flows alone suggest. For instance, it is reported that EU companies' subsidiaries in the US have sales in the US that are 3.6 times greater than the EU's exports to the US. This increased FDI is not evenly distributed globally, however. The UNCTAD World Investment Report (2001) points out that for 1998 to 2000, the EU, Japan and US accounted for 75% of inflows and 85% of outflows of FDI. The same regions combined account for roughly three-fifths of world-wide inward FDI stocks and four-fifths of outward stocks.

International Flows of Labour

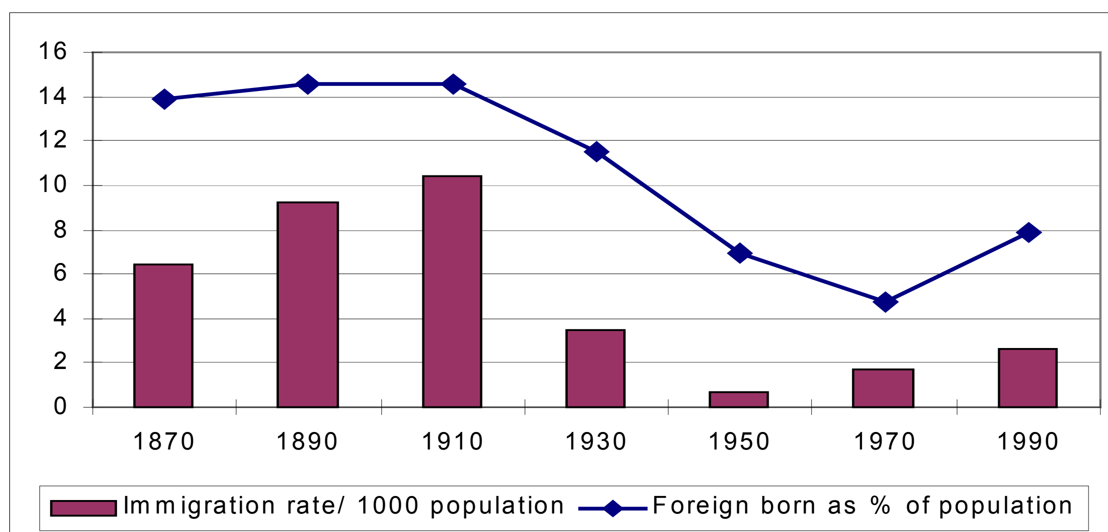
As a result of much lower transport costs, people travel around the globe far more than they used to. As a basic indication, the ATW World Airline Report (2000) states that in 2000, total world traffic reached 1.82 billion passengers. A significant proportion of these journeys will

[13] Kindleberger (1996).

not have been made for work purposes, but international business trips and short-term stays in foreign countries are facets of current globalisation.

However, long-term, international economic migration is not occurring on a huge scale by historical standards, in spite of the significant migration pressures that exist currently in a global economy in which wages for workers with similar skills vary hugely between countries at different stages of development[14]. The data in figure 4 clearly show that immigration into the US was much higher at the beginning of the 20th century than more recently[15].

Figure 4: Long-term Trends in US Immigration



Source: Crafts (2000) based on US Bureau of the Census data

Large-scale legal immigration into Western Europe was at its height in the high-growth decades that followed the Second World War, as countries such as France and the UK accepted many immigrants from their former colonies. Germany also accepted large numbers of guest workers during this period. From 1960 to 1973, the proportion of foreign workers rose from 3% to 6% of the workforce (Hall, 2000). This so-called "primary" immigration reduced very considerably after 1973.

B. Forces Driving Globalisation

Globalisation is a process that has been ongoing, albeit not in a linear fashion, over a long period[16]. The process is facilitated and driven by inter-related changes in technology, especially in communications and transportation, public policy – both domestically and at

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14 World Bank (2002), p. 44 cites a study that followed individual legal migrants. Workers moving from Mexico to the USA found they could increase their wages from $31 per week to $278 per week.

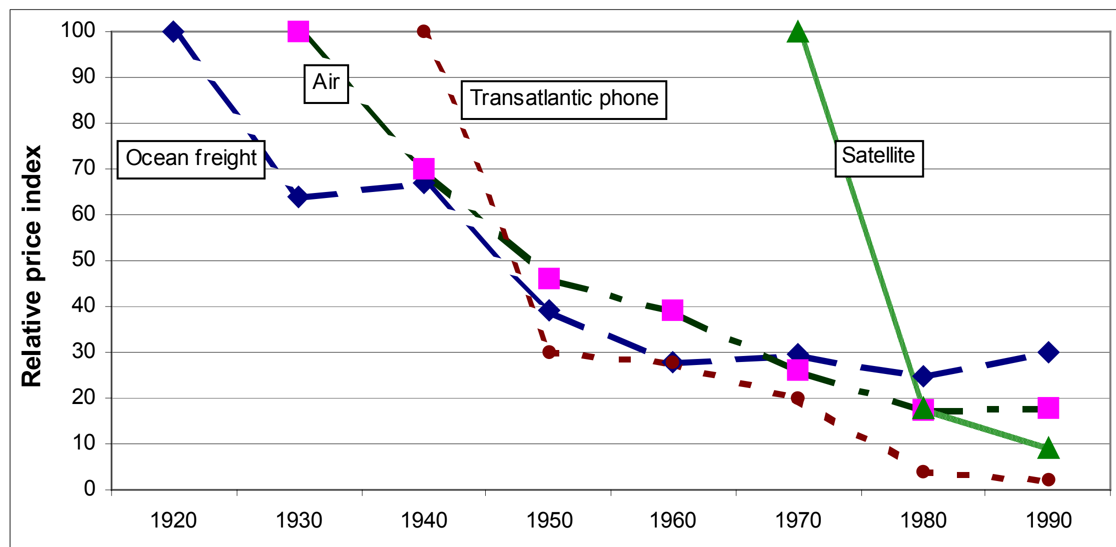
15 Hall (2000) reports an estimate that the US accepted about 1million immigrants - of which roughly 300 000 are illegal immigrants and refugees - annually in the late 1990s, relative to a population of about 275m.

16 World Bank (2002) argues that the term "globalization" is not appropriate pre 1870, whereas Mussa (2000) considers that the process has been ongoing since at least the Renaissance.

international level - and the preferences of individual citizens regarding what and where they wish to consume, save and work[17].

Technological Progress

Figure 5: Relative Transportation and Communications Costs



Source: World Bank (1995)

Technological progress has boosted the efficiency with which goods, services, capital, ideas and people move around the globe and has been a major driving force behind many of the phenomena described in the previous section. Figure 5 shows some of the technologies that have spurred this globalisation and demonstrates the steep price falls that occurred through the 20th century. More recent advances in information technology are discussed in detail in IMF WEO (Autumn 2001). An example of the precipitous price falls that have occurred for this technology is provided in Masson (2001): between 1960 and 2000, the price of "computers and peripheral equipment" relative to the GDP deflator fell by a factor of over 1800. Relative cost reductions on this scale make the technology widely available and have been instrumental in hugely increasing global information flows, for instance via the World Wide Web, which allow knowledge and new ideas to be disseminated around the globe more rapidly and in greater volume.

Public Policy

In addition to technological progress, public policy continues to play a crucial role in determining the extent to which countries participate in globalisation. As the inter-war period demonstrates, policy measures have at least the potential to reduce greatly the extent to which nations interact with one another, and so, at least temporarily, to reverse the course of globalisation. Since the Second World War, policies in many countries, albeit with

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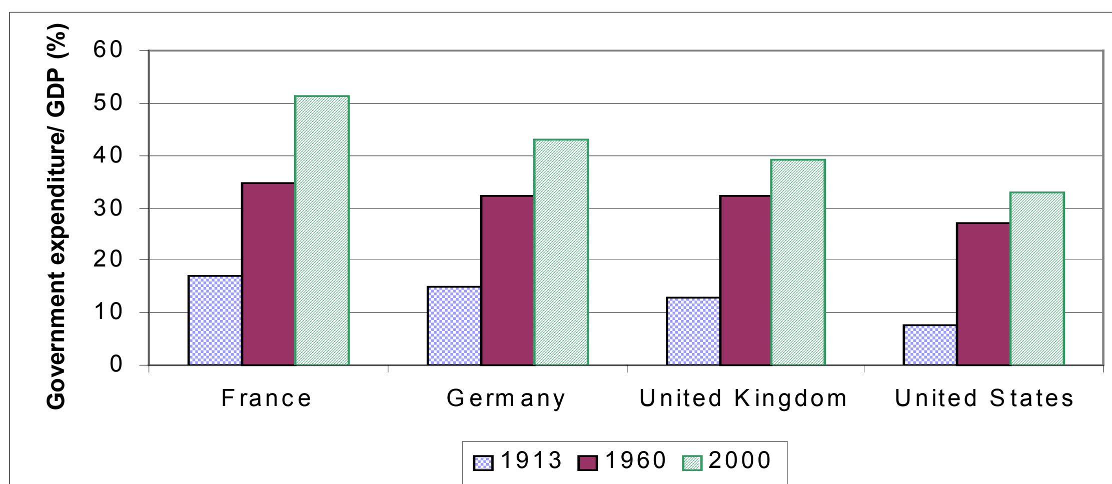
[17] An example of these inter-linkages is provided in Mussa (2000): "…centuries ago, wealthy people in Europe first learned about the tea and spices of the East as the consequence of limited and very expensive trade. The broadening desire for these products … hastened the search for easier and cheaper means of securing them. As a by-product of these efforts, America was discovered, and new frontiers of integration were opened up in the economic and other domains."

exceptions, have generally been supportive of international economic integration. Over this period, industrialised countries progressively opened their economies and a number of developing economies also began a process of external liberalisation, particularly after 1980[18]. In addition, the historic policy changes that signalled the end of the cold war in the late 1980s and early 1990s meant that a substantial number of countries became, to a far greater extent than had previously been the case, open to international flows of goods, services, people and ideas.

There remains, nevertheless, a significant group of countries that, partly due to policy choices, are not participating in the process of globalisation. However, dramatically improved communications technology means that citizens, even in very poor countries, are much better informed about political conditions and standards of living elsewhere. Technological progress itself may thus contribute to pressures for policy changes.

More generally, some authors have made a link between increased globalisation and the growth of the role of states in economic activity over the course of the last century (figure 6).

Figure 6: Total Government Outlays relative to GDP (1913, 1960, 2000)



Source: Commission services based on IMF and OECD data

Rodrik (1996) provides a theoretical justification for this by claiming that higher government consumption and intra-societal transfers play a risk-reducing role in societies exposed to greater external competition and thus uncertainty.

In addition, the 20th century, and in particular the period immediately after the Second World War, witnessed the creation of several international institutions and fora that provide governance at a level beyond national borders. These include the Bretton Woods institutions, the GATT/WTO and the wider United Nations system, which provides governance mechanisms in many fields through its programmes, funds and specialised agencies. Regional governance initiatives have also flourished in the 20th century, with the EU by far the most advanced regional example of supra-national governance.

[18] World Bank (2002a).

Part of the growth in the number of international organisations and agreements in many policy areas is due to attempts to deliver coherent international rules. Another major driver for the increasing economic role of governments and the creation of international bodies has been the *ex post* recognition of the limitations and failures of the previously existing institutional arrangements. This is particularly true of the period immediately after the Second World War. If the process of globalisation continues in future as it has during the past 50 years, it would seem likely that yet more traditionally domestic issues will become "international", implying that the trend towards the need for increased supra-national decision-making has yet to run its course.

The remainder of this section looks at some specific technological and public policy factors that have influenced the developments in international trade, capital and labour integration described above.

Trade Flows

The rapid growth in post-war international trade has partly been due to reductions in transport costs, such as those described in figure 5, but has also been the result of lower tariffs and trade barriers. Table 1 shows the evolution in the tariffs of selected major industrialised countries over the past 125 years. The positive post-war developments shown are not without their limitations, however. Protection remains high in agricultural and textiles sectors in most countries, and industrialised countries continue to apply relatively high tariffs on a small number of manufacturing sectors. Most developing countries continue to apply comparatively high tariffs across the board[19] even in manufactures. The poorest countries generally trade very little. With the reduction in tariff levels, non-tariff barriers to trade, such as product standards and anti-dumping regulations, have also become more important in recent years.

Table 1: Selected Tariff Levels Over the Past 125 Years

	1875	**1913**	**1930**	**1950**	**1989**	**Post Uruguay Round**
France	12-15	20	30	18		
Germany	4-6	17	21	26		
United Kingdom	0	0	17	23		
United States	40-50	44	48	14	4,6	3,0
EU					5,7	4,6

Source: Crafts (2000)

Nevertheless, the GATT/ WTO, set up shortly after World War II , has been a major innovation to the global trading system compared to the pre-war situation. Table 1 shows the rise in protectionism that occurred during the 1930s. No similar rise has occurred to date under GATT/ WTO, which has delivered consecutive reductions in the applied tariffs of its members and contributed to the elimination of quantitative restrictions, in parallel to creating a rules framework that provides greater predictability and transparency in international trade relations. Although heavily criticised from certain quarters in recent years, the GATT/ WTO, via the fundamental principles of MFN (Most Favoured Nation) treatment, non-discrimination

[19] For example, India's simple average bound tariff for manufactures after the Uruguay Round is 58.7%, WTO (2000).

and transparency and the binding of tariff obligations, has delivered a significantly more robust trading architecture than had existed previously.

Regional trading agreements (RTAs) have grown in number since the Second World War, particularly during the 1970s and 1990s. The EU, for example, has succeeded in completely removing tariff and quota restrictions on trade between members and has removed many non-tariff barriers to internal trade. Although a second best compared to multilateral liberalisation (bilateral agreements mean that non-members are discriminated against) the regional integration path can be used as a stepping stone towards developing countries' full integration in the international trade system. In particular, such arrangements can be an effective means of supporting the improvement of their domestic policy environment and their ability to create a climate conducive to economic growth and social development. In this context, there are strong arguments that "deep" RTAs that involve services and regulatory liberalisation should be based upon agreed multilateral norms.

Regional integration may also allow for efficiency gains in the regional market, which can pave the way for enhanced competitiveness in the world market and higher levels of investment and growth. In addition, RTAs offer useful fora for smaller countries to make their views heard internationally. However, unchecked regionalism has at least the potential to divert more trade than it creates and to undermine the primacy of the WTO as the multilateral rule-making body for international trade.

Capital Flows

The extent of international capital market integration depends heavily upon which policy instrument of international macroeconomics' "impossible trinity" of monetary policy, exchange rate policy and capital account convertibility countries choose to relinquish. At the end of the nineteenth century and up to 1914, the single global currency of the Gold Standard meant no domestic monetary policies, but encouraged international capital flows. The post-war Bretton Woods system on the other hand, allowed domestic monetary flexibility and fixed exchange rates given capital controls. Since the break-up of the Bretton Woods system, flexible exchange rate systems have made a comeback[20] and so have international capital flows, as countries have been able to liberalise their capital account. These policy choices partly explain the trends in figure 2.

Technological progress has played a key role in fostering faster and more efficient trading of traditional financial instruments and in the development of more complex financial products. Information technology has also enabled huge quantities of data to be sent around the world instantaneously and at minimal per unit cost. The gross daily trading volumes reported above are largely facilitated by information technology. Better information flows also facilitate the geographical and sectoral broadening of capital flows as lenders are better able to monitor borrowers.

Technological advances and innovations in methods of doing financial business provide part of the explanation for the changing composition of private capital flows. The 1990s surge in FDI is partly due to the growth of multinational enterprises and to many countries adopting favourable policies towards FDI. The trend was further supported by new FDI opportunities

[20] Within the EU, Member States first linked their currencies through the European Monetary System and ERM, and 12 Member States have now pooled their monetary sovereignty by adopting the euro as their single currency.

as a result of the "opening up" of numerous former Soviet Bloc countries, and the continued opening of countries such as China.

As in the trade sphere, the aftermath of the Second World War saw the creation of institutions (the IMF, in particular) to promote more stable international financial interaction. Further bodies were added to the governance structure of international finance as the century progressed. Although these institutions and bodies must adapt and develop to external developments, as in the trade sphere, global financial policymakers have a more mature set of financial bodies and institutions at their disposal now than at the beginning of the 20th century.

Labour Flows

Before the First World War individuals faced few policy restrictions upon where they chose to travel and work and levels of international migration were relatively high. However, in addition to linguistic and cultural difficulties, which continue to persist today for many migrants, the major barrier to international migration was that international travel was extremely expensive relative to ordinary incomes.

The situation at the beginning of the 21st century is quite different. Technological advances have dramatically reduced the costs of international travel. Short-term business (and holiday) travellers in general face relatively light restrictions in many countries. However, public policy in many countries restricts the rights that individuals have to settle and work in a foreign country[21]. Many EU countries welcomed economic immigrants in the high-growth period that followed World War II, but these policies were generally curtailed after the first oil price shock of 1973. The US continues to adopt a more liberal approach to economic immigration than the EU, and is estimated to admit about 1m million immigrants per year. Some EU countries have recently taken limited measures to encourage inward migration of skilled workers.

C. The Benefits of Globalisation

How has globalisation affected human welfare? The second half of the 20th century, a period of increasing global economic integration, saw a six-fold increase in world GDP (figure 1) while the global population increased about two and a half times over the same period[22]. These numbers translate into major improvements in the welfare and quality of life of many of the world's citizens, and not just in the richest countries. The past fifty years have seen major improvements in human life expectancies, basic hygiene, vaccinations against many communicable diseases, and lower rates of infant mortality. The period also witnessed improvements in domestic governance in many countries and a more robust set of international institutions and fora to deal with global policy challenges than existed during previous waves of globalisation.

Figure 7 shows the improvements that have been achieved in life expectancies between 1970 and 1997. The bars, relating to the left-hand axis, depict life expectancy at birth in industrial, middle-, and low-income countries[23] in 1997. Although low and middle income countries continue to lag the industrial countries, the catch-up indicated by the percentage increase in life expectancies since 1970, shown by the line relating to the right-hand axis, is striking. In

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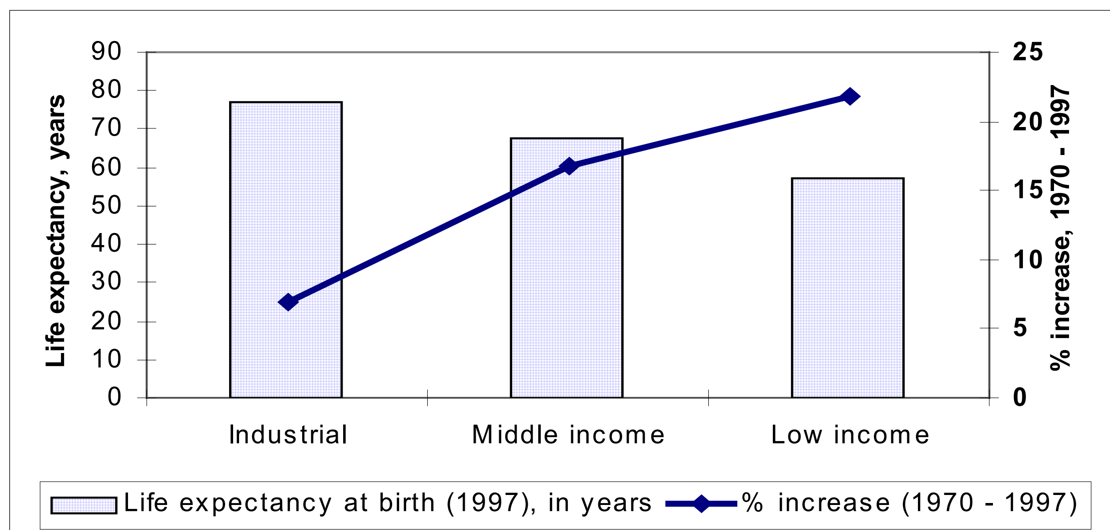
[21] The EU guarantees free movement of labour between members, but EU member states generally place strong restrictions on economic immigration by third country (non-EEA) nationals.

[22] IMF WEO (Spring 2000).

[23] World Bank definitions.

terms of numbers of years, low and middle income country citizens born in 1997 could expect, on average, to live 10 years longer than had they been born in 1970, whereas those born in industrial countries in 1997 could expect to live 5 years longer on average. These are major improvements, largely due to better hygiene and health standards, that globalisation has helped to spread[24].

Figure 7: Life Expectancy by Country Grouping in 1997 and Increase on 1970



Source: Commission services, based on World Development Indicators and IMF (2000a)

Correlation is, of course, much easier to observe than causation is to demonstrate and it is not simple to prove that the many benefits outlined above are also due to globalisation. Nevertheless, research indicates that countries that are able to pursue policies of external openness to foreign trade and capital, thus permitting the adoption of new technology and know-how, combined with respect for property rights and the rule of law domestically, have the best chance of rapid economic development. It is unlikely that any of these conditions is individually sufficient to deliver economic development, yet one of the most powerful observations in this debate is that there is not one example of a country that has achieved sustained economic growth by pursuing import-substitution policies of high trade protection (e.g. Masson, 2001). A reasonable degree of external openness would seem to be a necessary condition for sustained economic growth and continued poverty reduction.

Recent analysis from the World Bank identifies a group of developing countries - including China, India, Bangladesh, Vietnam and Uganda - which have opened up their economies to trade and investment in the last twenty years. Figure 8 compares the growth performance of these "post-1980 globalisers" with that of the rich countries and those developing countries that have not pursued international economic integration, the "non-globalisers". The figure clearly shows the superior growth performance of the "post-1980 globalisers" since they changed their policies. Of course, not all of the newly globalising countries have changed all of their international economic policies in favour of greater liberalisation. However, the research provides strong evidence of the beneficial effects upon developing countries' growth prospects of policies of international economic integration.

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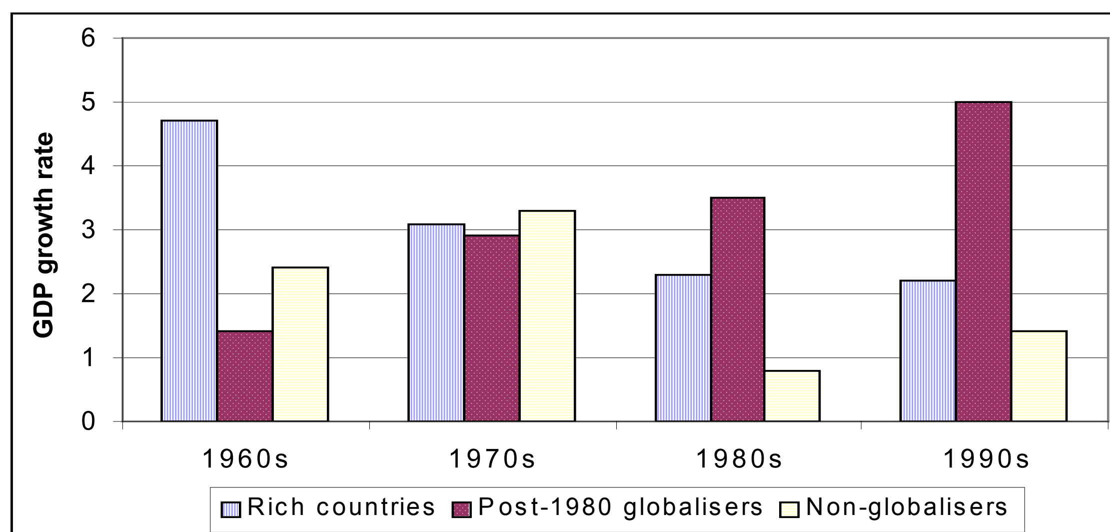
24 The AIDS epidemic has seriously slowed improvements in life expectancies in those countries worst affected by it.

Figure 8: GDP Growth by Country Grouping (1960 – 2000)



Source: Commission services based on Dollar (2001)

D. Challenges Facing the System

The major benefits that globalisation has brought to many have not come without costs. Major policy challenges remain to be tackled. These challenges include the leverage that national governments have in a world where competition may lead to a race to the bottom on social, environmental and other policies. A related issue is the provision of global public goods, which is seen as requiring close cooperation among governments and substantial amounts of financing. In this study, the focus is limited to those challenges that are related to the international financial and monetary system and to the issue of financing for development. In this context, three major concerns are related to trends in global income distribution, the increased volatility that may be associated with increased exposure to international trade and capital flows, and abuses of an essentially open international system.

National Governments in a Globalised World

Concerns have been expressed that the nature of today's liberal international financial system and the enhanced international competition implied by global market integration would increasingly curb the power of national governments to set rules and standards according to domestic public preferences and needs. While internationally mobile capital and regulatory competition between countries can help to discipline governments and enhance the efficiency of public institutions, it is argued that the political pressures created by the process of globalisation could place national governments in a regulatory race to the bottom that reaches well beyond the sphere of financial markets. Although economists[25] neither find significant evidence for governments losing power nor of a race to the bottom in environmental policies, labour market regulation or tax competition, the quality of labour and social standards, consumer and environmental protection are seen at risk[26]. This concern raises a host of questions, including the optimum level of decision-taking, i.e. national versus supra-national. Summers (1999) argues that a country that pursues greater international integration and

[25] See CEPR (2001).
[26] Deutscher Bundestag (2001).

ensures appropriate domestic policies can no longer pursue many national policy goals independently.

Global Public Goods

Some aspects of this perceived need for international multilateral collaboration in a globalising economy are highlighted in the concept of global public goods. Stability of the international financial and monetary system, an open trading system or the protection of global environmental commons (e.g. climate, bio-diversity) are seen as goods that can only be provided and maintained on the basis of international co-operative behaviour and support. These goods as well as other goals, such as communicable diseases control, knowledge, peace and security, can be interpreted as international or global public goods (Box 1). Their provision generates important externalities to the benefit of, in principle, all people around the world regardless of their individual contribution to the production of these goods. In the absence of a supranational enforcement power, this creates an incentive for the individual, or the individual state, to free-ride. As a result, investment in the provision of global public goods tends to be sub-optimal if the allocation decision is left to markets alone. An efficient supply of these goods would thus require the development and implementation of internationally accepted rules and standards as well as adequate financing.[27]

Box 1: Global Public Goods

Public goods can be classified according to their spatial dimension in local (e.g. streetlights), national (e.g. national defence), regional (e.g. environmental protection of in the Baltic Sea) and global public goods (e.g. the ozone layer). A global public good is defined as a public good, the benefits of which accrue to essentially all geographical regions. Depending on the type of public good, its benefits can accrue to present as well as to future generations. Examples of widely accepted global public goods include the protection of the global environment, communicable disease control, the fight against internationally organised crime and terrorism, international trade, international financial and monetary stability and international security. Others advocate adding elements that are considered key for the development process of low-income countries such as basic education, knowledge diffusion and public research.

In contrast to private goods, a public good is characterised by two typical properties: (1) *non-rivalry* or *non-congestion* and (2) *non-excludability* in consumption. Non-rivalry or non-congestion implies that a public good can be consumed (used or enjoyed) by any individual without (significantly) diminishing the possibility of consumption for others. Non-excludability means that it is either very costly or technically impossible to exclude non-payers from consuming the public good. In other words, the provision of public goods generates positive externalities for non-payers. Goods that feature both attributes are referred to as pure public goods. Most public goods are impure and permit either some degree of selective exclusion of non-payers or incur some rivalry in consumption. National defence is regarded as a typical (national) public good as no resident can be excluded from nor do residents compete for its benefits. The opposite from a public good is a *public bad*, which is equally defined by non-rivalry and non-excludability. Examples of a public bad are communicable diseases, organised crime and pollution. The provision of a public good can often be considered in terms of reducing or removing a public bad.

The provision of public goods constitutes a formidable policy challenge. As the allocation mechanism of the market is failing, the optimum supply level of public goods is essentially determined by public

[27] See for example Sandler (1997) and Kaul, Grunberg and Stern (1999).

choice. For pure public goods the lack of rivalry makes it unlikely for market clearing prices to emerge, and the problems of excluding non-payers from consumption make it difficult to establish property rights. These properties provide also a systematic incentive for consumers to understate the true value of their marginal benefit of consuming the public good and encourage free-riding. As a consequence, the provision of pure public goods on the basis of (voluntary) individual contribution through private agents alone tends to be sub-optimal.

In order to achieve socially desired levels, the public sector needs to support private contributions and/or provide adequate incentives to enhance voluntary private sector contributions. At the local and national level, governments support the provision of public goods through taxes levied on its citizens. At the global level, this collective action problem is compounded by several factors. Due to the lack of a supranational government, the provision of global public goods is the result of international decision making among sovereign states or entities and hence based on voluntary contributions from those states. Given the diversity of actors and depending on the nature of the global public good, the benefits and costs related to the provision of global public goods as well as the ability to contribute to their provision are distributed asymmetrically across countries and across generations. Although the benefits of global public goods essentially spread globally, there can be significant differences in their visibility across countries, regions and over time. In some cases such as curbing global warming, the bulk of the benefits will accrue to future generations, while the present generation bears the costs related to the provision of the global public good today.

The type and magnitude of resources required to support the provision of global public goods depends essentially on the nature of the public good and the way it is produced. The World Bank[a] estimates that annually some $ 16 billion go to finance international public goods in developing countries around the world and complementary domestic infrastructure that allows the absorption of these goods. These resources mainly support activities in health, environmental protection, knowledge creation and diffusion, and international peacekeeping. Instead of large-scale financing, the provision of public goods established on the basis of internationally agreed rules and regulations require the implementation of incentives for international co-operation and compliance. In some areas, such as international trade and the international financial and monetary system, multilateral institutions are in place to provide for the global public good and to discourage non-co-operative behaviour.

a) The World Bank, Global Development Finance (2001).

Trends in Global Income Distribution

There has been a great deal of recent academic work looking at the distribution and evolution of incomes across the globe and at the impact that globalisation, and in particular more liberal trade, has had upon income distribution. The literature stresses several important distinctions. Global income inequality can occur due to a mixture of income inequality between countries and within countries. It can occur because all are growing, but the rich are growing faster (absolute improvement, but relative worsening) or because the poor are getting poorer in absolute terms. In assessing whether or not globalisation has caused more or less income inequality, a distinction needs to be drawn between those countries that have pursued policies of increasing international integration and those that have not. Further, it is important to try to distinguish the effects of "globalisation policies" of increased openness that countries may or may not have pursued from other simultaneous (domestic) policy changes that may also have affected income distribution.

Given differences in measurement methods and data problems, different authors emphasise different aspects of trends in income inequality. Between 1900 and 2000 the world Gini coefficient rose from 0.40 to 0.48, implying an increase in global income inequality over the period (IMF, 2000). Lindert and Williamson (2001), using data from Bourguignon and Morrisson (1999), report that between 1820 and 1992, global income inequality rose and was almost entirely due to increased inequality between countries, since within-country inequality

has shown no marked trend. However, the picture may have begun to change in recent years. World Bank (2002) emphasises the post-war convergence in real incomes among developed countries and notes that the "post-1980 globalisers" have also begun to catch up with the rich countries (Figure 8), although there has been a simultaneous increase in within-country inequality in a number of countries. CEPR (2001) takes the view that global income inequality increased greatly during the 19th century, as some countries industrialised and others did not, continued to rise in the first half of the 20th century, but has changed little during the past fifty years. In terms of broader measures of welfare, life expectancies have increased significantly over the past fifty years in many developing countries, such that life expectancy convergence with the developed world has been much greater than income divergence.

However, extreme poverty continues to exist. The World Bank estimates that the number of people living on less than 1 dollar per day was roughly constant through the 1990s at 1.2 billion. At the regional level, East Asia and the Pacific have made sustained progress in most areas, while South Asia and Sub-Saharan Africa lag far behind. The impressive growth of East Asia and the Pacific is reflected in the improvements in the ratio of its income to that of high-income OECD countries, from around 1/10 to nearly 1/5 over 1960-98. In Sub-Saharan Africa the situation has worsened dramatically: per capita income, around of 1/9 of that in high-income OECD countries in 1960, deteriorated to around 1/18 by 1998. The share of people living on less than $1 a day is as high as 46% in Sub-Saharan Africa and 40% in South Asia, compared with 15% in East Asia and the Pacific and Latin America. In terms of growth, the performance of Sub-Saharan Africa has been disastrous: between 1975 and 1999 GDP per capita growth averaged –1%.

Economic theory suggests that liberalising trade should equalise factor incomes between countries, yet it is not clear that this is occurring[28]. The recent work of the World Bank (2002) and Dollar and Kray (2001) argues that one must look at whether countries have embraced market opening "globalisation policies". As noted above, "post-1980 globalisers" have achieved superior growth performance compared to both rich countries and "non-globalising" developing countries. In addition, the "globalisers" did not, on average, experience higher income inequality. As a result, the poor shared in the benefits of higher per-capita GDP growth. However, some economists have criticised the methodologies used in cross-country work of this nature[29], and others have noted the lack of good case studies in this area[30].

The Dollar and Kray work focuses on the globalisation policies of developing countries. However, this chapter has noted that technological progress is a major driving force of globalisation. This process may well be increasing the premium available to skilled workers in all countries. This may tend to increase inequality between the skilled and the unskilled within countries, including in rich countries. Globalisation may thus increase the need for appropriate domestic policies to deal with the problems faced by low-skilled workers.

Whilst the evidence on recent trends in income inequality is not clear-cut, modern media technology means that all are aware of the differences in standards of living between rich and poor countries and regions. As such, it is a pressing policy issue. The effects of "globalisation policies" are probably too subtle to be categorised as simply good or bad for income

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28 International labour migration is, in theory, a substitute for liberal trade policy that should also lead to more equal factor incomes, but, as shown above, current globalisation is better characterised by freer trade than freer international migration.

29 Rodriguez and Rodrik (2001).

30 Bhagwati and Srinivasan (1999).

inequality. Globalisation is likely to benefit substantially in aggregate those countries that are able to participate in it, but it does create adjustment costs which may be concentrated on some segments of the population, such as low-skilled workers in industrialised countries. The policy challenge is therefore to think through these complex interactions of policy and technological change and to conceive of mechanisms that can help those that may lose from globalisation, whilst allowing countries to reap the aggregate benefits.

Increased Exposure to Volatility

Increased external economic integration as a result of globalisation brings with it increased exposure to international economic events and thus economic shocks. Perhaps the most obvious manifestation of these shocks comes in the form of financial crises that have affected both rich and developing countries. In times of crisis there is a tendency in financial markets for a "flight to quality" of international capital, such as to the sovereign debt of rich, stable economies. This can leave emerging market economies and developing countries without access to new short-term international capital or at prohibitive rates. More generally, internationally traded commodities and exchange rates may diverge sharply from "fundamentals" due to swings in market sentiment. These swings may be particularly difficult for countries without diversified production structures to accommodate.

Price volatility is, of course, not only an international phenomenon. A diversified set of international buyers for the output of an open economy may serve to limit price fluctuations faced by domestic producers relative to those that would prevail in a closed economy. International economic integration may also bring access to international markets in insurance (e.g. futures markets) that smaller, closed domestic markets would not be able to support.

In spite of this, recent financial shocks in developing countries and emerging market economies have had significant negative economic consequences (Masson, 2001). In particular, actual or potential macroeconomic instability may severely limit the extent to which private individuals are willing to engage in long-term investment in an economy. The next chapter will discuss in detail possible reforms to macroeconomic and financial frameworks that could improve upon the current situation.

Abuses of the International Financial System

There is increasing concern about the international financial system's vulnerability to abuses[31]. Characterised by a high degree of openness and by the rapid development of new financing and payment tools, it has become more difficult to control the international financial system against abuses such as money laundering, the financing of criminal and terrorist activities, tax evasion and the circumvention of rules and standards. In some cases, corporate entities are deliberately established for such purposes.

Financial abuses can threaten the credibility and undermine the integrity of the international financial system. Their consequences affect countries at every stage of development and involve both onshore and offshore financial centres. The existence of abuses encourages illegal and criminal behaviour, including bribery and corruption. Moreover, there is concern that harmful tax practices could trigger reductions in tax revenues and limit the ability of governments to provide for public goods at the socially desired levels.

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[31] See for example Group of Seven (2000b).

CHAPTER II: THE INTERNATIONAL FINANCIAL SYSTEM IN A GLOBALISED WORLD

The occurrence of financial crises in various parts of the world in the last decade, and their impact on the economies of the affected countries and their population's living standards, has led to an intense debate about the causes of this new wave of financial instability. Much of the focus of policy makers has been on the soundness of the local financial sector, the consistencies in macroeconomic and structural reforms policies of the countries concerned and the appropriateness of their exchange rate regime. In addition, however, the question has arisen whether the international financial and monetary system more generally is still adequate to face the challenges of our time, in particular the globalisation of business and finance.

At the very general level, the international financial system consists of a set of principles, rules, decision-making procedures and institutions structuring the relations between states and private entities in the financial area. It provides the structure in which economic and financial activity takes place. While sound policies at the country level are clearly central pre-requisites, the main focus of this chapter will be on the role of an efficient international financial system for ensuring global financial stability. The chapter will first briefly characterise the evolution of the international financial environment (section A). Following a typology of the functions one could expect from a 'first-best' international financial system, adapted to the existing conditions of a globalised world economy, it will then present an analysis of some of the challenges that the current system poses to policy makers (section B). Section C will review proposals for dealing with these problems and for improving the overall architecture of the system.

A. Trends and Achievements

Globalisation has changed many aspects of how people, organisations and businesses operate. It affects societies and countries all over the planet in ways that are often difficult to predict. Perhaps more than in any other domain of economic activity, globalisation has had profound repercussions on the financial sector and on international financial and monetary relations. As a result, the rules, principles, and decision-making procedures that govern the system differ today quite substantially from those prevailing at the time of the Bretton Woods agreements in 1944.

Trends that characterise the evolution of the international financial system include:

- **Deeper integration of international financial markets, where major assets are traded almost continuously by a wide number of operators**. In addition to the large financial enterprises that are connected to essentially all major financial centres, a growing number of increasingly diverse operators participate in international financial markets, including individual investors, pension and mutual funds, industrial enterprises and hedge funds. The emergence of this global financial market place owes much to the accelerating pace of technological progress in the field of Information and Communication Technologies (ICT), which has resulted in the availability of vast amounts of information[32], and in increasingly cheaper technical means to process it. This integration process is, however, far from being completed. Cross-border transactions remain generally more costly than domestic

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[32] See for example Hull and Tesar (2001).

ones; regulations continue to differ across countries and market participants do not share similar access to information and/or processing capabilities.

- **Evolution of the role and function of exchange rate regimes.** The Bretton Woods system was based on fixed but adjustable exchange rates to avoid excessive volatility and to prevent competitive devaluations while allowing for adjustment within an international framework. Today, exchange rates between the three major currencies fluctuate freely. Many industrial countries and emerging market economies have opted either for hard pegs (such as currency board arrangements, dollarisation or a single currency) or for floating rates resulting in a "hollowing out of the centre of fixed but adjustable rates".[33]

- **Fuller liberalisation of capital markets.** This again contrasts with the features of the Bretton Woods system, where capital movements were heavily restricted (and continued to be even in some industrialised countries until the eighties). Capital controls have been dismantled in many countries because they were viewed as significant barriers to further economic development. In addition, they were increasingly perceived as ineffective instruments for maintaining exchange rate stability and an independent monetary policy. The pace of the drive towards capital liberalisation has, however, slowed down substantially following the emergence of financial crises in the middle of the nineties. It is now widely recognised that a strong domestic financial sector is a prerequisite for successful capital account liberalisation, which itself should be properly sequenced. The debate on capital flow liberalisation is now, inter alia, focusing on the possibility of introducing temporary capital controls in crisis situation and on the use of capital controls on inflows (such as in Chile) as part of a banking and financial system strengthening effort.[34]

- **The development of a large pool of savings in the developed world in search of returns and risk diversification.** Income growth, the ageing of populations, the development of pension and mutual funds and the liberalisation of capital movements in many parts of the world have been among the factors enticing cross-border investment. The availability of these large pools of savings in search of returns and diversification is often regarded as a two-edged sword[35]. On the one hand, when global markets correctly price the risks and returns associated with different investment opportunities, cross-border capital flows promote an efficient allocation of global savings to its most productive uses. It also allows developing countries, which may have low levels of saving, access to a larger pool of international capital. In particular, it allows developing countries to complement their domestic savings, thereby enhancing their growth potential. On the other hand, cross-border capital flows are also highly sensitive to relative yields and risk developments and are thus prone to substantial swings. In addition, these funds can exceed the "absorptive" capacity of developing countries and their financial system.

- **A change in the level and composition of capital flows to developing and emerging market economies.** Gross capital flows to these countries have risen considerably as a share of GDP since the early 1980s. At the same time, net private flows to these countries that hovered around 0.5 % of GDP during the 1970s and the

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[33] For an in-depth discussion of the phenomenon, see Tavlas and Ulan (2002).
[34] Eichengreen (1999).
[35] See for example Buch and Pierdzioch (2001).

beginning of the 1980s rose sharply to reach 3% of GDP in the mid 1990s but fell back to 1.5% at the end of the decade.[36] Foreign Direct Investment (FDI) and equity flows have been playing an increasingly important role while syndicated bank lending and official assistance are declining. This phenomenon has been particularly visible during the last decade. FDI flows have become the most important and stable source of financing for these countries. This might be attributable, on the supply side, to the reduction of restrictions on cross-border equity investment and improvement in communications that have reduced the costs of acquiring information on assets abroad. On the demand side, explanatory factors are the broad improvements in the overall macro-economic fundamentals of developing countries, their opening to international capital flows and the wave of privatisations[37]. However, these increased FDI and equity flows are heavily concentrated on a limited number of countries. The structure of external debt flows has also changed substantially with bonds substituting for a decline in bank lending.

- **The development of a wider array of increasingly complex financial instruments.** The rapid growth and development of new and more complex financial instruments, such as over-the-counter (OTC) derivatives, has run in parallel with the emergence and development of internationally active financial institutions. These changes were made possible by spectacular advances in ICT. These new instruments, by allowing financial risks to be better tailored to yield expectations and risk preferences, have contributed to a more comprehensive set of market instruments and have improved market liquidity and depth. However, they require increasingly sophisticated management tools of financial risk assessment which often use the same mathematical models and techniques. Also, "OTC derivatives activities can contribute to the build up of vulnerabilities and to adverse market dynamics in some circumstances"[38], as demonstrated by the 1998 Long Term Capital management (LTCM) incident.

- **The emergence of new international fora and the development of sets of multilateral and national rules, codes and standards.** Besides the evolution of the existing institutions, the last decade has seen the creation of a number of international fora and bodies and the establishment of new sets of standards, rules and codes including data dissemination, fiscal, monetary and financial policy transparency, banking regulation and supervision, foreign exchange management, securities and insurance regulation, accounting, auditing, bankruptcy and corporate governance. This creation of new fora and the establishment of new rules runs in parallel with a deregulation process of the economy characterised by a drive towards more flexibility (in labour, product and services markets) and the liberalisation of trade and financial flows. It might also be the result of the inadequacy of older rules to the working of the present system and the need for new ones. Associated with this trend is a debate about the legitimacy and efficiency of both existing bodies and newly created fora.

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[36] Mussa, op.cit.

[37] Lane, Milesi-Ferretti, Gian Maria (2000).

[38] Schinasi (2000).

B. Systemic Issues

The characteristics of the current international financial market place make it different and to a large extent more challenging than the one prevailing up to the 1980s. As a result, the ability of the international economic and financial system (that was built in the aftermath of World War II and that was partly modified in the early seventies) to deal with current challenges has become the object of close scrutiny.

Any assessment of the performance of the present system is, explicitly or implicitly, based on views on the main functions that the international financial system should perform. These views are, by definition, normative. For the purpose of this report, the following assumptions have been made about the functions, objectives and requirements that a first-best international system should fulfil:

- It should **promote the international distribution of savings.** It is in the interest of all countries that the large pool of worldwide savings, mostly originating from developed countries, can be invested in those countries with more profitable investment opportunities. This includes developing countries, which are often short of domestic capital, and offer high returns on investment. A smooth flow of savings would require an efficient payment, clearing and settlement system; solid financial institutions and markets that are able to intermediate international savings flows efficiently; recognised legal standards and norms for international contracts; and well-developed information and communication infrastructures.

- It should support the **adjustment of payments disequilibria.** For a multitude of reasons, countries do sometimes face unsustainable debt levels and/or large payments imbalances that can lead to liquidity or solvency crises. In these circumstances, while the burden of adjustment must fall mostly on the country itself, other countries have an interest in ensuring that the international spill-over effects of domestic adjustment are contained. Examples of this common interest include large depreciations of the exchange rate of a country, where tensions may arise between the exchange rate adjustment supporting the adjustment process and the impact of the depreciation on other countries' trade and economic positions. More generally, in a world of floating exchange rates, there can be instances of strong negative externalities if all countries follow strategies of competitive devaluations. This requires the existence of policy co-ordination mechanisms to avoid the occurrence of such a non-co-operative and sub-optimal equilibrium.

  The same holds for cases where a country follows an inconsistent macroeconomic policy that can lead to a rushed exit of foreign investors and precipitate an external payments crisis which can affect other countries. Also, it is important for the international system to ensure that countries' external debt and/or deficits do not become too large and unsustainable. This calls for international support for domestic adjustment efforts, through international mechanisms of policy surveillance and dialogue, and, were justified, external financial assistance.

- It should help to **promote financial stability, i.e. avoidance of excessive volatility and boom-bust financing cycles**[39]. Sound and sustainable domestic macroeconomic and financial policies are of primary importance to ensure financial stability. For

[39] Wyplosz (1998).

countries willing to attract international capital (be it in the form of portfolio investment, direct investment in industrial or services businesses or through the issuance of international securities) it is important that investors have a clear understanding of the direction of economic policy, the state of the economy and the policy framework of the authorities. This would argue, inter alia, for international standards and rules on issues such as transparency, accounting and disclosure of data.

- In times of financial stress, it should **ensure monetary stability,** meaning the provision of international liquidity when there are risks of a generalised blockage of international financial relations because of the unwillingness or incapability of economic agents to conduct financial transactions or to take on financial risks. Given the deep interlinkages between modern financial markets and financial institutions, a serious shock to the financial system can lead to the quick disappearance of liquidity. Provisions are then needed to prevent financial and economic crises[40]. This may be seen as an example of the need for an international public good[41], which is not provided necessarily by government in normal times but becomes necessary in time of crisis. Recent years have seen at least two occurrences of such severe financial shocks. In the case of the failure of LTCM, no lender of last resort intervention was needed but the US central bank did intervene to assemble a coalition of domestic and foreign financial institutions to come to the rescue of the failed institutions, highlighting the need for international liquidity support. Second, in the wake of the 11 September attacks against the US, the need for international liquidity was met by swap arrangements between the Federal Reserve Bank of the US and the European Central Bank[42].

- **It should have an efficient governance framework.** The above mentioned functions of the international financial system may require common bodies and institutions, mechanisms of co-operation and co-ordination and - where required - mechanisms that support and set penalties for the implementation, or lack thereof, of the commonly agreed rules. Such a framework will raise questions of efficiency and legitimacy.

Overall, the system has functioned well in channelling savings into productive investment and fostering prosperity and productivity growth in both developing and developed economies. Market discipline has generated a growing consensus regarding the merits of stability-oriented macroeconomic policies. Broad and deep markets are seen as key for the efficient pricing and management of risks, which in turn is looked at as a necessary condition to expand the range of financing opportunities at the disposal of actors, including in developing countries, many of which would otherwise be perceived as too risky by individual investors. Moreover, international competition in the financial sector has helped to reduce financing costs, rendering the intermediation of savings to investment more efficient and disciplining economic policies.

Nevertheless, recent experiences have brought to the fore a number of real or potential systemic weaknesses. The recurrence of financial crises in recent years has suggested that the system is not fully adequate any more to cope with the changed environment. In addition, it

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[40] Or an international financial crisis manager, as per Rogoff (1999).

[41] Kindleberger (1988).

[42] Indeed, as argued by Rogoff (1999), page 22, there is no need for a new global institution to provide such liquidity. Cooperation among the key central banks is however crucial.

has been seen as allowing abuses in terms of money laundering, financing of illegal activities and tax evasion, and has segments that are largely unregulated.

B.1. International Monetary Stability

Although the integration of financial markets and the institutional and regulatory framework in which they operate have spurred economic growth, the international monetary and financial system has continued to be criticised for being crisis-prone. With the exception of the ERM crisis of 1993, the crises of the nineties have mainly affected developing countries and, for most of them, have had important consequences in terms of output loss, welfare, social conditions and unemployment. While there have been other historical periods when crises occurred at a relatively high frequency, in particular in the late 19th century and the 1920s and 1930s, the nature and systemic impact of crises in recent years has become a cause for concern.

Key features of the crises and of the environment in which they took place include:

An increased frequency and intensity. Compared to the Bretton Woods period, the frequency of crises post 1973 has doubled Bordo (2000). Crises have continued in the nineties, including Mexico (1994), East Asia (1997-1998) and Russia (1998). Turkey (2001) and Argentina (2001) are the most recent examples. While it is often claimed that in addition to becoming more frequent, modern crises have become more damaging, Bordo (2000) does not find evidence that recent crises have grown longer or output losses have become larger.

The multiplication of actors involved. Compared to the debt crises of the eighties, the current wave of financial crises are more difficult to deal with given the dominance of market-based financing, which involve a large number and variety of investors. When bank and official lending dominated international financing, the number of actors involved was much lower and it was easier to reach a co-operative solution. In the absence of a clear framework of crisis resolution, there is in addition an issue of moral hazard that has been linked to the provision of large international financial rescue packages to countries affected by capital flight.

The increased risk of crises becoming contagious and self-fulfilling. Contagion is not a new phenomenon; in the past, financial crises have often spread across countries. However, under the Bretton Woods regime of low capital mobility and limited linkages among key financial markets, contagion was less pervasive. On the contrary, recent years have seen a new wave of contagion crises, where countries that had relatively sound economic fundamentals were subject to speculative attacks. Contagion happens when market participants, because of developments in other countries, consider that economic fundamentals in a country have to be fundamentally re-assessed and that the price of its financial assets have become overvalued. Contagion has been most evident in the ERM crisis of 1992/1993, in Asia in 1997 and in Latin America in 2001. Contagion has also been exacerbated by financial market participants' tendency towards herd behaviour, i.e. the preference to follow the market's directions in order to minimise the risks associated with more extreme positions. The advances in information technology and risk management techniques, which have been adopted by most of the financial industry and often rely on similar models of risk evaluation and management, have reinforced the scope for this type of behaviour.

In addition, if market participants become convinced that there is some underlying factor justifying the possibility of a crisis, a crisis can become self-fulfilling. For example, foreign

investors may sell the financial assets of a country that seems in good condition because this country is affected by a similar economic shock, it shares similar structural conditions (financial sector structure, debt levels) or it belongs to the same class of assets as an affected country. It is usually impossible to anticipate in advance which macroeconomic element or structural condition the markets will focus on to justify their expectation of a crisis, since almost all countries have economic weaknesses in some form or another.

Lastly, it has been claimed that the globalisation of financial markets has led to the faster transmission of economic and financial disturbances more generally with, in addition to the trade channel as a transmission mechanism, a greater synchronisation of business cycles across the world (IMF WEO Autumn 2001). Moreover, flexible exchange rate systems have only partly succeeded in insulating economies from international disturbances.

The increasing scope for information asymmetries. Information asymmetries mean that participants in a financial transaction do not have the same quality of information to evaluate the prospects of the transactions being carried out successfully. Typically, for example, a borrower has more information on his financial perspectives than the lender. With the globalisation of markets, the multiplication and diversity of investors involved in international financial transactions, the dominance of market-based finance relative to the more traditional bank financing, and the vast amount of information to be processed, information asymmetries have become more pervasive.

Pervasive information asymmetries have had two broad types of concrete consequences in the international financial area in recent years.[43] First, they tend to lead to credit rationing when lenders believe that they do not have the proper information to evaluate properly the riskiness of a proposed financial transaction. This may lead for example to a situation whereby good corporate risks in developing countries cannot access external financing directly because lenders do not possess enough information about the country, the company and its business. Second, and conversely, information asymmetries have led to boom cycles of capital towards some types of financial assets, for example, emerging market bonds or shares of telecommunications companies, as investors only focussed on the positive information.

The increased size and volatility of private capital flows towards developing countries. Following the two oil shocks, developing countries attracted record amounts of foreign capital, mostly in the form of traditional bank loans (syndicated or not). The prospects of default by Mexico and Argentina in the early eighties precipitated the end of this cycle of large capital inflows. In the early nineties, however, following the liberalisation of their capital accounts, a new cycle of private capital flow to developing countries began, but was stopped and reversed towards the middle of the decade in the wake of the Asian crisis.

A characteristic of this more recent reliance on external financing has been that a number of countries have taken on large debt-creating inflows with short-term maturities. Because they are often unable to borrow locally and with long term maturities, it is tempting for developing countries' governments and enterprises to borrow on international markets. Most of the borrowing takes place in foreign currencies (because of lower interest rates and easier availability than when borrowing on the local market in the domestic currency) and at relatively short term maturities (reflecting foreign lenders' preference for reducing their risks).

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[43] See for example Devenow and Welch (1996).

Foreign borrowing is particularly attractive under fixed exchange rates. However, if foreign investors decide to withdraw capital 'en masse', the economy is presented with a two-faced crisis. The first one is a traditional liquidity crisis; current financial resources are insufficient in the face of short-term maturing obligations and refinancing becomes difficult, if not impossible. In addition, because of the currency and maturity mismatches in the balance sheets of local banks and enterprises resulting from borrowing short term in foreign currency, the liquidity crisis can very rapidly translate into a solvency crisis. If a devaluation results and under the new macroeconomic conditions, the expected cash flows generated by the operations of local banks and companies are not adequate to meet their financial obligations.

B.2. Abuses of the Global Financial System

The global financial system has increasingly been used to 'launder' revenues generated by illegal activities, such as drugs related crime, and to channel funds to people and organisations involved in illegal activities, such as terrorism. The increasing ease of transferring funds across borders, the very extensive networks of all main banks (through their correspondents) and the growing number of countries that have opened their capital account imply that it has become more difficult to control the origin and the ultimate destination of funds entering the global financial system. Moreover, it has become increasingly clear that corporate vehicles are being used in money laundering and tax evasion schemes, organised criminal activity, and as a way to circumvent regulations and manipulate equity markets.

There are no estimates of the amount of money that is being processed in the international financial system to finance terrorist activities. With respect to money laundering, the IMF is quoted as estimating the aggregate size of money laundering in the world as being between two and five percent of global GDP, or roughly 600 to 1500 bn USD[44].

The abuse problem has been compounded by a number of countries and jurisdictions that have built their competitive advantage through very favourable tax and regulatory environments for non-residents funds, while at the same time limiting their co-operation with the judicial, tax and police authorities of other countries. In addition to providing an accommodating environment for money laundering and other crime-related financial activities, these jurisdictions undermine the ability of other governments to finance essential public goods and services by providing easy opportunities for tax evasion by non-residents. As a result, decisions on where to locate economic activities are distorted and the tax burden in the affected countries is shifted towards law-abiding taxpayers.

There are few estimates of the size of financial flows to financial and tax havens, and the available figures do not distinguish legitimate investments from investments resulting from the harmful features of these jurisdictions. However, they clearly highlight the growing importance of financial flows to these jurisdictions while showing the peculiarities of these flows. Hines and Rice (1994) note that tax havens account for only 1.2% of world population and 3% of world GDP, but they attract 26% of assets and 31% of profits of American multinationals[45]. According to the OECD, foreign direct investment by companies in G7 countries in a number of low-tax jurisdictions in the Caribbean and in South Pacific island states increased more than five-fold over the period 1985-1994, to more than $200 billion, a rate of increase well in excess of the growth of total outbound Foreign Direct Investment[46].

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44 See http://www1.oecd.org/fatf/.
45 Hines and Rice (1994).
46 OECD (1998).

In addition to the concerns associated with the misuse of the financial system, there are other worries that are related to the intensified linkages between markets, intermediaries and infrastructure and which may become sources of risk to systemic stability and hence to the economic stability of countries that participate in the international financial system. These worries relate to the growing use of sophisticated financial management techniques, a greater reliance on in-house procedures for risk assessment and, in particular, the regular recourse to leverage as a means to magnify potential gains on investment positions.

Highly leveraged institutions – mainly hedge funds - play an important role in the international financial system by facilitating the efficient sharing of investor risk. However, the activities of hedge funds are often characterised by highly speculative behaviour. This behaviour of hedge funds, which are typically constructed so as to avoid regulation, has long been a source of concern to policymakers. The background to the most recent bout of concern about highly leveraged institutions was the destabilising effects of the Long Term Credit Management crisis in the autumn of 1998 and the earlier crises in South-east Asia and Russia.

The abuses, misuses and lack of regulation of the global financial system have been made easier because of the slow and difficult co-operation among cross-border judicial, tax and policy authorities. It should, however, be noted that the events of 11 September have significantly changed the position of some policy makers, in particular the US administration with regard to their assessment of the costs (in terms of compliance costs for financial institutions) and benefits (in terms of preventing illegal activity) of greater international oversight on financial flows as well as pressure on non-cooperative countries where practices have been adjudged to favour illegal financial activity. As the next section will show, there are increased efforts being made at international level to address these challenges.

C. Towards a More Stable and Better Functioning International Monetary and Financial System

Recent years have seen the emergence of numerous proposals on how best to adapt the international financial and monetary system (IFMS) to the changes and challenges of a global economy. While this reform drive was accelerated by - and became more public with - the frequency of financial crises in the 1990s, it is not a new phenomenon. Previous decades had seen other proposals to reform and adapt the IFMS to the evolution of economic and financial relations and to changes in relative economic and political powers. Examples include the creation of the WTO, which was preceded by the GATT but which became a fully-fledged international organisation only in the mid-1990s.[47] Others, even highly publicised ones, have had rather limited effects: already in 1974, the UN General Assembly adopted the Declaration and the Action Plan for a new world economic order.

This section on proposals for reforming the system limits itself to the current policy debate and to the main proposals. It provides a short analysis of the pros and cons of these proposals, their political and practical feasibility as well as an assessment of the necessary conditions for success.

For the purpose of this report, the reform proposals have been grouped into four categories: modalities of crisis prevention and management (C.1), initiatives to reduce the abuses of the international financial system (C.2), regional and global co-operation (C.3), and reform of the

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[47] See for example Gardner (1980).

institutional framework (C.4). These broad categories address to some extent the perceived failures in the working of the IFMS that were developed in the previous chapter.

C.1. Modalities of Crisis Prevention and Management

In the wake of the financial crises of Mexico in 1994/1995 and in South-East Asia in 1997/98, a discussion re-emerged about the instability of the IFMS and its proneness to financial crises. The financial crises were seen to expose significant problems in the functioning of international financial markets and of the system governing them. These problems included the following:

- Most participants (the IMF, like most other international institutions, major policymakers and credit rating agencies and private investors) were taken by surprise;
- Capital inflows had been mismanaged by emerging market economies, with excessive short-term indebtedness provoking a rush for the exit by investors, thereby accentuating the severity of the crisis;
- Private creditors were perceived to have taken excessive risks, a fact which was attributed to deficiencies in information provision and processing but also to the creation of expectations about an official bail-out (either by the debtor country or the international community) – the 'moral-hazard-problem';
- IMF-led assistance packages were perceived to be both huge from an historical perspective and in relation to the financial resources of the Fund and "too limited" to contain panic and prevent very severe fall-outs in crisis countries;
- There was a sentiment that whereas gains from risky investments - that contributed to the crises - were accrued by the private sector, the official community (i.e. ultimately the taxpayer) had to pick up the bill when investments turned sour. While this was not true across-the-board (equity holders suffered huge losses in many crisis countries), the concern was valid with respect to short-term creditors, who had to a significant extent been able to limit their losses.

Against this background, calls were made to adapt the set of rules and practices governing the IFMS, and the role of the International Monetary Fund in it, to the challenges of free and large capital flows. These calls for reform were not only made by academics, journalists, or civil society but also came from the G7, other governments and indeed from the Fund itself.

Some of the proposals to make the international monetary and financial system less prone to crises are listed below, separating probably somewhat artificially the ones pertaining to crisis prevention from the ones related to crisis resolution. Some initiatives are in the process of being implemented reflecting a high degree of consensus of the international financial community; others lack at present sufficient political support or would imply a too high level of public intrusion in the markets. Whereas most of the proposed changes are being dealt with in the existing framework, some of the more ambitious ones require the creation of a new institution or a much more profound reform of the architecture.

C.1.1. Crisis Prevention

At crisis prevention level, i.e. ex-ante measures to improve market participants' risk assessment, strengthen market discipline and thereby minimise the risk of crises, much has been achieved but some suggestions for further action and progress have been made.

- There is general recognition that pursuit of **sound policies** and the existence of sound macroeconomic and structural framework remains the major and essential condition for reducing the occurrence of financial crises. Sound policies require a continuous effort to which the IMF, through its surveillance, and private market participants, through the feedback they give to authorities, can contribute. Sound policies are, however, not always sufficient since financial market participants may fail to differentiate sufficiently between good performers and bad ones, are sometimes prone to herd behaviour or need sometimes to withdraw their funds from sound investments to meet margin calls in other markets[48].

- Many efforts have been devoted to improving **the flow of information** to market participants. Initiatives were taken in order to obtain better quality and more timely information from countries (such as the IMF Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS), and the Data Quality Reference sites (DQRS)[49], at improving information disclosure by policymakers to markets (such as Public Information Notices (PINs), publication of Letters of Intent and Article IV Staff reports, fiscal, monetary and financial transparency codes) and at getting feedback from markets through the organisation of a more permanent dialogue between the IMF and market participants. This drive towards better information is also reflected in the progress with respect to information processing by the IMF itself through improved Fund surveillance and the development of early warning, or vulnerability, indicator systems.

  However, this approach also has its limits. Perfect information is an illusion. The existence of information asymmetries in capital markets is a well known fact of financial life since a borrower, whatever the standards and his willingness to respect them, will always be better informed about his situation than his creditors. Standards can also sometimes induce perverse behaviour by creating a false sense of confidence and/or introducing a bias towards some type of capital flows or in favour of some specific countries without proper risk assessment. Moreover, standards and codes are not value-less and major political differences continue to exist about what they should cover, how normative they should be and how they should be implemented and/or enforced. Also, since the need for information on the economic situation and policies of a country depends, to some extent, on its access to financial markets and levels of development, an appropriate balance needs to be found between the voluntary or compulsory character of standards. Finally, efforts have so far concentrated on information to the markets, while it has been suggested that

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[48] For an more in-depth discussion of capital market dynamics in both mature and emerging markets, see for example the bi-yearly IMF publication "International Capital Markets, Developments, Prospects and Policy issues" and in particular the September 1998 issue.

[49] The SDDS was established in 1996 to guide countries that have, or that might seek, access to international capital markets in the dissemination of economic and financial data to the public. And the GDDS was established in 1997 to guide countries in the provision to the public of comprehensive, timely, accessible, and reliable economic, financial, and socio-demographic data.

creditors could also be more transparent by releasing information on the composition of their asset portfolios.

- Efforts to make countries less vulnerable to crises have also been geared at developing **deeper and more liquid financial markets and at strengthening domestic financial systems.** These efforts have been made by, or are underway in, not only emerging market economies but also in advanced countries since many of them experienced during the recent past or are experiencing (Japan) more or less acute forms of banking or financial crises[50]. However, as recently demonstrated[51], banking crises tend to have a bigger negative impact, in GDP terms, in emerging market economies than in advanced countries because the former tend to rely more on bank financing in light of their level of economic and institutional development. Banking crises, because they tend to spread to the whole financial sector and to the whole economy, have generally much more acute (direct and indirect) costs for the economy than stock or bond price variations[52].

  Strengthening prudential regulation and supervision are among the most important micro-prudential tools to foster financial stability and to prevent financial crises. World-wide, supervisory efforts are currently directed at developing a sharper focus on the risks within a financial institution. G-10 countries, under the auspices of the Bank of International Settlements, have reinforced their role in preparing regulatory recommendations in the banking field that will set capital adequacy standards for the international community at large. Work is also underway on the convergence of supervisory practices.

  These efforts are complemented by the extension of IMF surveillance to domestic banking and financial systems through Financial Sector Assessment Program (FSAP) and Financial System Stability Assessments (FSSA). These exercises aim at identifying ex-ante the strengths and vulnerabilities of a country's financial system and how to address them. Increasing the governance and regulation of financial institutions in developing countries and emerging market economies is another priority, which runs in parallel with these IMF efforts.

  In addition, some policymakers argue that the development of a securities market should become a priority for emerging market economies[53]. Deep and liquid securities and bond markets, however, require a legal and institutional framework (including disclosure requirements, contract enforcement, market rules and corporate governance) that takes time and costs to develop.

- In the framework of the G-20 it has been argued that the **strengthening of the country's foreign exchange reserves** should become a priority for emerging market economies' policymakers. In that view, emerging market economies need a sufficient buffer of foreign exchange reserves relative to their debt (short term debt generally) in order to re-assure market participants about their ability to service their debt. While there is agreement that adequate foreign reserves are obviously confidence

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50 Several European countries were hit by financial crises in the beginning the 1990s, notably Sweden, Finland and Norway (Bank of Finland 2001).

51 For instance in Goldstein (1998).

52 See IMF (1998).

53 See for instance Tsang (1998).

enhancing, it is difficult to determine a single level that would, irrespective of circumstances, provide insurance against market attacks. Moreover, holding excessive reserves can be costly for the central bank and the economy.

Progress is also being made on the following fronts but at a slower pace because these proposals are either of a less consensual nature or more difficult to implement in practice.

- The IMF is stepping up its efforts to develop an **early warning system**[54] but also to stimulate emerging market economies' policy makers to clarify, during Article IV consultations, their possible policy responses to crises. While this approach has the advantage of increasing the preparedness of the IMF and debtor countries to potential crises, economic and political circumstances evolve rapidly and the intrinsic element of a crisis is surprise. Moreover, care needs to be taken to avoid that an IMF assessment would itself precipitate a crisis.

- Though there seems to be a wide consensus on the theoretical merits of including **collective action clauses (CAC)** (majority action clauses, sharing clauses and representation arrangements) into new international bond issues of emerging market economies, implementation has been rather limited. CACs are expected to facilitate the inclusion of international bonds into comprehensive debt restructuring operations, and to improve the pricing of risks by bondholders. Some, however, fear that the inclusion of such clauses will increase the financing cost to emerging market economies. Industrialised countries also differ on the idea of "leading by example" by introducing these clauses in their own international bond issues. Progress on CAC clearly necessitates a 'critical mass' of countries to move forward.

- The idea of **creating Clubs of Creditors** is also appealing.[55] Such clubs would bring together all creditors of sovereign debtors and would allow to disseminate information among them on the situation of the debtor country so that they could collectively adopt more rapidly and efficiently the best solution in case of crisis. It would be preferable to establish them prior to crises and they could usefully complement CAC. These clubs would play a role similar to the ones of bank advisory committees in the eighties or the so-called London clubs in the first part of the century. Private market participants have so far been reluctant in organising themselves in such a way because they fear that by doing so they would implicitly facilitate default by sovereign debtors. Without international official financial community lobbying, there is little chance that they would take the initiative.

- There is also a wide agreement that emerging market economies should develop and/or broaden the **use of financing instruments** that can be used as a first line of defence in case of crisis. Such instruments include private contingent credit lines (as already established e.g. by Argentina and Mexico) and call options in inter-bank loan contracts that would enable debtors to 'lock in' loans in the event of a crisis. As such, they reinforce official foreign exchange reserves, allow a better pricing of risk by market participants and enable debtors to hedge against their risks more efficiently. They are, however, quite costly and difficult to operate in practice since the 'trigger event' should neither create self-fulfilling crises nor moral hazard. Moreover, recent

[54] See Köhler (2001).

[55] See for example Eichengreen et al (1995a) and Eichengreen (1999). Some countries, such as Brazil unsuccessfully tried this approach.

experience such as in Argentina has shown that calling on these credit lines might cause a full risk re-assessment by private creditors thereby provoking capital outflows and/or the evaporation of other sources of capital inflows.

- Though the principle of free international flows remains solidly anchored in the IMFS and is considered to be a final objective for all countries, **capital account liberalisation** has been heavily discussed**.** International private capital flows have become the major source of finance and investment for essentially all emerging market economies. This process will probably extend itself to developing countries, perhaps with the exception of the poorest ones. The merits of opening up to capital inflows are widely acknowledged. However, while countries should be encouraged to open their capital markets, it is necessary to ensure that this takes place within an orderly and well-sequenced process. Whether and to what degree multilateral institutions should promote this process or even be given jurisdiction over capital movements remains an issue for discussion.

  There is widespread consensus that capital account liberalisation needs to be orderly and well-sequenced, starting preferably at the long end (including with FDI) and that the process should be consistent with the overall stability of the economy and, in particular, the soundness of its financial system. At the same time, one needs also to recognise the distortional effects of capital controls and the tendency to see their effectiveness erode over time. This provides an incentive to liberalise further the capital account.

  The role of the international community in the capital account liberalisation process has not been fully settled. The Asian crisis, which was widely perceived as linked to inappropriately sequenced capital account liberalisation, has reduced support for proposals to amend the IMF Articles of Agreement to make capital account liberalisation one of the purposes of the Fund. Such an amendment would not only provide an explicit legal base for the inclusion of capital account issues into Fund surveillance, which is taking place anyway, but would also enable the Fund to include capital account liberalisation into program conditionality and give the Fund jurisdiction over capital movements. The latter option would establish an obligation for members to liberalise them, which would broadly mirror the Fund's competence with regard to current account transactions.

- Within that debate of capital account liberalisation, the question of **taxes on capital inflows** has received renewed attention. These taxes can take the form, as in Chile, of non-remunerated deposits for capital inflows but could also proceed as taxes or quantitative ceilings on short term foreign financial flows. They can, as shown by various studies[56], encourage longer term financing from international investors and thus discourage more volatile capital inflows. It is argued, however, that they need to be broad-based to avoid creating loopholes; temporary since their persistence would encourage tax evasion; and complemented by measures to strengthen the financial system.

Finally, a number of proposals have yet to gather sufficient support.

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[56] Eichengreen and Mussa (1998).

- Soros proposed in the midst of the 1997-1998 crisis of emerging markets the **creation of an international debt insurance agency scheme** that would be financed by a fee paid by borrowing countries[57]. The mechanism would operate on the basis of a country-specific ceiling on international borrowing that would be assessed by the IMF in light of the country's financial and economic situation. This mechanism would require that the IMF would only be prepared to provide assistance to countries respecting the ceiling. If debtor countries were to borrow in excess of the ceiling, markets would be expected to request a higher risk premium to cover default.

  The advantages of this proposal are a better pricing of risk (if the ceilings are assessed correctly); the avoidance of rush to exit in countries respecting the ceiling; and the implicit rejection of bail outs for countries disregarding the ceiling. However, it is quite difficult to set an economically sound ceiling, independent of changing economic and political circumstances and based on economic considerations only. Moreover, a few large international borrowers have already borrowed in excess of what could be reasonably considered as an economically sound ceiling and would thus not qualify. There are also doubts about the actual relevance of differentiating domestic/international borrowing and private/public debt and about whether the IMF (and the international financial community) would be in a position to refrain from intervening in support of countries disregarding the ceiling, particularly the systemic ones. The cost of borrowing for all emerging market economies (insurance fee and risk premium for unsinsured) would increase.

- **The creation of an international prudential supervisory agency** has recently been proposed as a way to address the dichotomy between national supervision and globally operating financial institutions[58]**.** As financial markets become more integrated, new rules are being developed within various fora such as the BIS, the FSF, the IMF/WB, the FATF and the OECD. These rules, codes of conduct, and standards to be implemented rely most of the time on the goodwill of countries. Under the proposal, they could be made compulsory and would be monitored by the international agency. This would have the advantage of making the rules more explicit, ensuring a level playing field, thereby possibly increasing information about the health of internationally active financial institutions. In case of crisis, co-ordination will be facilitated and the risk of contagion would diminish. The idea, however, requires a high degree of global political consensus since questions about the legal and enforcement powers of this international agency over financial institutions, national supervisors and central bankers would have to be settled.

C.1.2. Crisis Resolution

At crisis resolution level, progress has been more limited. The balancing exercise between adjustment by the debtor country, official financing, and private financing has become more complex than 20 years ago. Financial markets have grown more rapidly than the financial resources at the disposal of the Fund and the reserve assets of creditor countries. Capital market participants are more diverse and numerous and reaching a co-operative solution among them and the debtor country is much more arduous. Moreover, whereas sovereign borrowing used to dominate emerging market country financing, borrowers are now public institutions, financial companies and corporate entities, which sometimes benefit from an

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57 Soros (1998).
58 Kaufman, Henry (1998).

implicit or explicit public guarantee. Finally, most capital account restrictions have been removed, facilitating the use of official assistance money for capital outflows.

The question also arises whether, and to what extent, the balance should be tailored to specific country circumstances. While it has been claimed that the wide and varying number of actors, both on the debtor and creditor side, increases the need for a common framework for crisis resolution in order to ensure some fairness, some of the reform proposals acknowledge, sometimes explicitly[59], that "systemic" countries - those that could trigger contagion or are politically most important - need to be treated differently. Such a case-by-case approach to crisis resolution, however, gives the main IMF shareholder an advantage in influencing the terms of each rescue operation.

The IMF is currently engaged in a process of reviewing the conditionality attached to its financing. There is broad agreement that conditionality needs to focus on those policies that are critical to achieving the macroeconomic objectives of the programme[60]. The question of how to associate the private sector in the resolution of crises has also received a lot of attention. Related to this discussion, proposals have also been formulated for a more radical change in the role of the IMF in handling country crises.

- There is a consensus, at least on paper, on the need to **further develop the principles for Private Sector Involvement,** that were laid down in the IMFC Prague framework to involve the private sector in both the prevention and the resolution of financial crises. The objective is to provide clearer guidance for market participants, debtor countries and the official creditors. The key principles of the framework include:

  - the commitment to honour contracts whenever possible;
  - equitable burden sharing between the public and private sectors;
  - comparable treatment of different classes of creditors;
  - main responsibility for restructuring with debtor countries;
  - assessment of the need for PSI on the basis of (a) the country's medium-term payment capacity and (b) its chances of regaining market access quickly. Depending on the situation, the program could then either (1) rely on the catalytic capacity of the Fund, without PSI, (2) call for voluntary and temporary arrangements to overcome problems of creditor co-ordination or (3) involve an actual debt restructuring or reduction.

  However, this framework is work in progress and needs to be further operationalised.

- The international community has until now failed to devise a **clearer and more solid legal framework for standstill, debt restructuring, and debt reduction**, in case a country cannot secure adequate voluntary participation in crisis resolution from its private creditors. Under a standstill, a country would be allowed to suspend temporarily payments on some, or all, of its external obligations. This would force market participants to reconsider and could reduce herd behaviour.

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[59] International Financial Institutions Advisory Commission (2000).

[60] IMF Public Information Notice No. 01/125.

The option of a standstill could be made more credible if IMF access limits were applied more strictly. Market participants would realise that huge bailout packages by the Fund would become unlikely and that, unless a voluntary agreement is reached, a standstill would be possible.

A standstill could also gain acceptance if accompanied by an extension of the Fund's policy of lending into arrears for bonded debt. This policy initiated in the eighties for commercial bank debt allows the IMF to provide financial support to a country which is in arrears but is negotiating in good faith with its creditors. By doing so, the Fund encourages a positive outcome from discussions between the debtor country and its creditors. However, such a policy for bonded debt could trigger lawsuits by creditors with the objective to attach the IMF money, a risk less present with commercial banks that can be subject to official moral suasion.

The Fund could also consider backing a standstill by making use of Article VI of its Articles of Agreement, which allows the institution to request a member to exercise controls on capital outflows in order to be eligible for the Fund's general resources. A Fund endorsement of a standstill would mitigate somewhat the detrimental long-term effects on a country's international standing. However, this might also prove insufficient to prevent litigation.

Preventing litigation would probably require an amendment of the IMF Articles of Agreement. This approach is being debated following a speech by the IMF Deputy Managing Director at the end of November 2001[61] when she presented a proposal for an international debt workout mechanism. This mechanism would take the form of a framework offering a debtor country legal protection from creditors that stand in the way of a necessary restructuring, provided that the debtor negotiates with its creditors in good faith and to put in place policies that would prevent a similar problem from arising in the future.

This approach would have the advantage of avoiding disorderly debt restructuring. It could also contribute to a more stable international financial system if it could help to correct market perceptions that the official sector will bail out private investors in case of crisis. The approach could lead, in a first instance, to a reduction of capital flows to emerging markets but simultaneously also to a better risk assessment by creditors.

However, an international debt workout mechanism requires a very broad consensus (85 % voting power majority for an amendment of the IMF Articles) since these rules would have to be applied by the whole membership. If the Fund, and not another international institution, is empowered to sanction temporary capital controls, it could also be seen as playing the rather irreconcilable roles of referee and financial provider. This could create a climate in which a crisis could be triggered when the Fund starts to be involved in a problem country. Moreover, reflection will be needed on how to determine if and when the mechanism is formally set in motion; how to ensure the debtor behaves appropriately while he is enjoying protection from his creditors; the level of financing that should be provided by the IMF; and the type of debt to which the stay and the binding-in of minority creditors would apply.

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[61] Krueger (2001).

- A different approach is the proposal of **fundamentally changing the IMF lending rules to transform the IMF into a international lender of last resort (LOLR)** (See Calomiris[62] initial proposal which led to the Meltzer proposal[63]). The IMF (or the to-be-created international central bank) should only lend short term, at a penalty rate and with collateral to its member countries meeting a set of pre-conditions related essentially to a well- capitalised and open banking system (Calomiris) or to sound economic fundamentals (Meltzer). The LOLR approach attempts to address the moral hazard problem associated with IMF assistance, by restricting IMF lending to sound (illiquid but solvent) debtors that face contagion. Both authors assume that the incentive to pre-qualify - and thus for pursuing sound policies or having a sound financial system - would be strong since this would be the only financing window available to countries. Being perceived by financial markets as having sound policies and a sound financial system would be a permanent requisite for emerging market economies since losing the pre-qualification status would almost automatically imply huge capital outflows. Private capital markets would indeed be expected to request a higher risk premium for countries that do not pre-qualify and thus reduce the incentive for over-investment in emerging markets.

  The question remains open as to what should be done with countries that do not meet the conditions any more and with countries that do not yet meet the pre-conditions. The proposal would also deprive most of the IMF membership of financial support in their adjustment efforts. Most importantly, the LOLR proposal assumes that the international official financial community would abstain from reacting if a non pre-qualified country would be hit by a crisis. The country would have to face its adjustment process and the interaction with private creditors without Fund support. The problems of the LOLR function are illustrated in someway by the fate of the Contingent Credit Line (CCL), a facility which has some features of a LOLR. The CCL shows how difficult it is to have pre-qualification be a substitute for ex-post conditionality and how hard it will be for emerging market economies to continue being perceived as having sound policies.

C.1.3. Excursion: Currency Transactions Taxes

International currency transactions taxes (CTT) have been proposed as a way to reduce exchange rate volatility and undesired fluctuations in short-term capital movements. This section will review some of the major CTT proposals from the perspective of their relative effectiveness and efficiency in achieving these objectives.

Within the development community, including development NGOs, proponents of currency transaction taxes have emphasised their potential capacity to generate public revenue. This aspect will be discussed in the context of promotion and financing of development in chapter III.

The Concept of Currency Transaction Taxes

The basic idea of discouraging speculative capital transactions through taxation has a long history in economic theory. Against the background of the differences of investment practices in the UK and the US prevailing at that time, Keynes already in the thirties presented the idea

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[62] Calomiris (1998).

[63] International Financial Institutions Advisory Commission (2000).

of a transactions tax to counter speculation[64]. Nobel-prize winner James Tobin re-launched the idea in 1972 and refined it in 1978, when he proposed "to throw some sand in the wheels of our excessively efficient international money market".[65]

In light of the breakdown of the Bretton Woods system and the liberalisation of capital movements, Tobin's primary objective was to give individual countries greater autonomy over monetary policy. By limiting the scope of capital movements, a currency transaction tax would be expected to expand the room for independent monetary policy. The currency transactions tax would discourage short-term capital movements by making the rapid taking and unwinding of financial positions more costly. Tobin argued that most of the daily transactions were speculation and arbitrage, and contributed little to the efficient allocation of long-term investment world-wide.[66]

According to Tobin's original proposal, the general levy of a flat and low tax rate (1 percent) on all spot transactions would imply a much stronger disincentive for the taking of short-term positions than for transactions related to longer-term investment and financing horizons. There was thus no need to distinguish between speculative and non-speculative transactions and the administration of the tax could be simplified. Proceeds of the tax would remain with national authorities.

While the idea of a currency transaction tax did not receive much attention in the eighties, it came to the forefront of the international debate in the mid-nineties. It was argued that short-term capital movements were at the root of financial and economic crises, hampering development and nourishing poverty in many developing countries.

In 1996, Spahn proposed a variant of the Tobin tax. In his view, Tobin's original scheme would create liquidity problems for the day-to-day operations of financial markets while not being effective in case of strong speculative forces. The Spahn version is based on a two-tier approach: while a tax would apply to all foreign exchange transactions and to all financial transactions taking place in the secondary market of financial derivatives at a normal rate of 0.02%, a special exchange surcharge would be levied in periods of exceptional exchange rate turbulence. This implies the ex-ante adoption of some kind of target zone for the exchange rate around a (moving) central rate. The surcharge would apply only when the exchange rate was moving beyond the limits of the agreed fluctuation band. The tax base for the surcharge would correspond to the fraction of the value of the transactions carried out above or below the defined exchange rate band.

Schmidt (1999) argued that the implementation of a Tobin-type tax was technically feasible, provided that the tax would be levied at the level of the centralised payments systems. This system is also used for interbank foreign exchange transactions and has details of all gross transactions in its electronic transfer systems. Schmidt also suggests that implementation of the tax by offshore financial centres can be enforced because of the strong links between developed countries' central banks and offshore netting systems and securities exchanges. In

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[64] "The introduction of a substantial Government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States. […] Casinos should, in the public interest, be inaccessible and expensive, perhaps the same is true of Stock Exchanges…". However, Keynes also pointed to the dilemma that "if individual purchases of investments were rendered illiquid, this might seriously impede new investment". See Keynes (1936) as quoted in paperback edition Keynes (1964) pp.159-160.

[65] Tobin (1978) and (1984). See also Summers and Summers (1989).

[66] United Nations Development Programme (1994).

order to foster compliance with the tax, central banks could refuse access to their payment and settlement systems if a jurisdiction would not comply with the rules. Central banks would act as tax collectors, making a new international institution for collecting the tax proceeds unnecessary.

Impact on Financial Markets

Impact on trade volumes, liquidity and volatility

Assuming that reducing exchange rate volatility is indeed a desirable goal[67], concerns have been expressed that by reducing the volume of market transactions, liquidity will tighten and as a consequence volatility actually may increase instead of being reduced as intended.[68] A universal currency transactions tax is expected to increase the bid-ask spreads, deterring primarily arbitrage transactions. Arbitrage transactions form a large share of foreign exchange transactions. They take advantage of very small differences in the prices or yields of assets of similar types. These transactions are usually associated with very low costs (i.e. very low bid-ask spreads). They take place in the context of financial institutions' risks management daily operations. Such daily foreign exchange transactions have a similar equivalent in daily liquidity management operations in domestic currencies, where banks exchange vast amounts of money on the inter-bank money market.

According to studies carried out by the French Treasury[69] and under the auspices of the Finnish Ministry of Finance[70], both of which use similar methodologies for their estimates, trading volumes are expected to fall significantly following the introduction of a currency transaction tax. For example, with a price elasticity of one[71] and an initial bid-spread rate of 0.02% (i.e. the typical transaction cost before tax on the inter-bank and bank/dealers foreign exchange market), the introduction of a 0.1% tax would reduce the volume of transactions by 83%. With an elasticity of 0.5, the reduction would still amount to 69%[72]. The volume of transactions is expected to decline more the higher the tax rate, the higher the elasticity and the smaller the initial transactions cost[73].

The reduction in arbitrage trading would affect the liquidity of all markets. Markets in developed countries and trading among developed countries' currencies would be mostly affected, because the lion's share of currency transactions are carried out among developed countries' currencies. The following eight currencies pairs (USD/EUR, USD/JPY, USD/GBP, USD/CHF, USD/CAD, EUR/GBP, EUR/CHF and EUR/JPY) accounted for 76% of the daily foreign exchange turnover in April 2001, with the two first pairs alone representing 50%[74].

Transactions among developed and developing countries' currencies or transactions among currencies of developing countries account for a much lower share of the total foreign

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67 Some argue that a certain amount of volatility is inherent in the normal functioning of the national and global financial systems, as it reflects differences in business cycles, discrete shocks, the evolution of risk premia, and changes in expectations (see Financial Stability Forum (2000)).

68 See Group of Seven (2001).

69 French Government (2000).

70 Ministry of Finance, Finland (2000).

71 An elasticity of one means that the volume of trading falls by one percent when the transaction cost rises by one percent.

72 See Ministry of Finance, Finland (2000), Table A4, page 56.

73 Indeed, the smaller the initial transaction costs, the more the total cost increases after the introduction of the tax.

74 See BIS (2001b).

exchange turnover. Trading in local currencies in emerging markets represented about 4.5 percent of all transactions in 2001, compared with 3.1 percent three years earlier. The Hong Kong dollar, the Singapore dollar, the South African rand and the Mexican peso were the most widely traded emerging market currencies, accounting together for 5.3 percent of the average daily turnover in April 2001.

In general, lower liquidity bears the risk of higher price volatility, which is the opposite of the desired effect. Despite their relatively low share in international foreign exchange markets, higher transactions costs related to the introduction of CTT could have disproportionately strong effects on the markets of developing countries, where liquidity and trade volumes are already comparatively small. Empirically, however, no simple link between the volume of trading and volatility can be established. For instance, while the trading volumes on the US dollar/yen market fell between 1998 and 2001, the volatility of the bilateral exchange rate in this period did not substantially fall from that observed in the preceding period[75].

Impact on market structure and costs

Analysis suggests that a CTT is likely to contribute to the acceleration of the changes in the structural characteristics of the foreign exchange markets.[76] Characterised by the decentralised nature of transactions and the predominance of dealer-to-dealer transactions until now, the introduction of a CTT is expected to further encourage the concentration of the market, which is already taking place under the joint forces of Internet trading platforms and concentration in the banking industry.

CTTs may also drive up costs of financing across the board. Eichengreen (1996) argues that the higher cost of currency transactions due to CTTs would be felt by all economic agents, including those developing countries' exporters and importers that rely on foreign trade and cannot use their own currencies in their operations. This may have an impact on their price competitiveness, which could counterbalance potential cost savings from reduced exchange rate volatility. In addition, depending on the degree of competition in the market and the ratio of price-supply and price-demand elasticities, the higher cost of foreign transactions may be passed on to final customers.

Impact on speculative flows

Proponents of currency transaction taxes often argue that, apart from reducing volatility, the tax could help in discouraging large speculative trading operations[77]. There is obviously a trade-off between on the one hand effectively discouraging potentially undesired capital flows and on the other hand not to unduly discouraging international transactions and ensuring sufficient liquidity to the markets.[78] It is generally acknowledged that at a low rate, the tax would be an insignificant cost in times of currency turmoil. But even at the relatively high rate of 1% (2% on a round trip), a currency transaction tax might not prevent speculation, which is usually associated with the expectation of strong exchange rate movements, e.g.

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[75] Between April 1995 and April 1998, the exchange rate of the yen fluctuated between 81 yen for one dollar and a peak of about 135 yen to a dollar. Between April 1998 and April 2001, the fluctuations were within the 101-147 range. See BIS (2001b).

[76] See Conseil supérieur des Finances du Royaume de Belgique (2001), page 64.

[77] Again, some argue that this should not be by definition beneficial to the countries themselves; see for instance Soros (2001), who points out that the adoption of CTTs could reduce the disciplining function of integrated capital markets.

[78] See for example the report of the French Government (2000) or the report from the European Banking Federation (2001).

when market participants consider that a country's fixed exchange rate has become unsustainable and is on the verge of being abandoned. A simple calculation shows that, at a rate of 1%, the tax would not deter a one-week speculative position if there were a 50% probability of a 4% devaluation during the week. A higher probability and/or a higher expected exchange rate change would make the speculative position taking more profitable than the tax.

Taking this challenge into account, Jetin (2001) argues within the framework of Spahn's two-tiered approach, that the tax rate would need to be allowed to increase to " (…) much higher levels than was expected until now". Alternatively, he suggests to design a variable CTT with the tax rate being a function of the depreciation or appreciation rate of the foreign exchange rate. Depending on the details of the function, this could imply a prohibitively high transaction taxes in times of crisis, essentially mimicking the effect of a standstill.

C.2. Reducing the Abuses of the Financial System

Money Laundering and Harmful Tax Practices

There is an increasing awareness of the need to tackle all sources of international financial abuse in order to guarantee a fair and more efficient economic system. Opaque tax and financial systems and the absence of effective co-operation with foreign authorities in some jurisdictions - in particular a number of financial and tax havens - make it very difficult to curb tax evasion or money laundering. Most states have, however, realised that it is in their best interest to agree on a number of common standards in the financial and tax fields and recognise that a certain co-ordination of fiscal or financial policies can increase their autonomy regarding domestic policies.

A number of fora aimed at improving standards of financial regulation and at eliminating harmful practices are now in place. These include the Financial Stability Forum (FSF) of the G7, the Financial Action Task Force (FATF) and the Forum on harmful tax practices of the OECD.

The Financial Action Task Force (FATF) was established in 1989 and comprises 31 members, including the European Commission and the 15 EU Member States. It adopted in June 2000 a report aimed at identifying unco-operative states and territories in the fight against money laundering. Until now, 19 countries and territories have been considered unco-operative. A dialogue has started with these jurisdictions to encourage them to put an end to their unco-operative practices and modify their legislation. For the countries and territories that maintain their harmful practices, defensive measures will be implemented. So far, defensive measures have only been proposed against Nauru which take effect from 30 November 2001.

The G7 Financial Stability Forum (FSF) was created in 1999 with the objective of assessing vulnerabilities in the international financial system, identifying and overseeing action needed to address those vulnerabilities, and improving co-ordination and information exchange among the various authorities responsible for financial stability.[79] The FSF has worked on several topics, including the activities of highly leveraged institutions and offshore financial centres. In a report published in April 2000, the FSF identified three groups of jurisdictions

[79] The Forum has a total of 40 members: 25 from National Authorities, 14 from International Financial Institutions, Regulatory and Supervisory Groupings and Committees of Central Bank Experts and a chairman. The FSF meets usually twice a year (spring and autumn) but can meet as often as needed to carry out its functions.

with regard to adhesion to minimum standards of transparency and co-operation. The group III, which is characterised by a lack of transparency and co-operation, includes 25 jurisdictions towards which the FSF proposes co-ordination of international initiatives.

The OECD Forum on Harmful Tax Practices was set up in 1998 following the publication of the OECD report "Harmful tax competition. An emerging global issue". A list of 35 jurisdictions meeting the tax havens identification criteria set out in that report has been published in June 2000. A dialogue aiming at encouraging these jurisdictions to adopt fair tax practices is currently undertaken. Since the start of its work, the Forum has obtained 11 political commitments to co-operation[80]. In 2002, the adoption of defensive measures towards unco-operative jurisdictions will be proposed on the basis of a list of unco-operative jurisdictions established as at 28 February 2002.

Within the European Community, important progress has been achieved in the fight against money laundering and harmful tax practices. The Council and the European Parliament adopted a revised and improved directive on money laundering on 4 December 2001, in order to make it more comprehensive and to ease the fight against international terrorism and other criminal activities. In the tax field, substantial progress towards the elimination of harmful tax practices has been achieved in the framework of the tax package endorsed by the Council on the 1st of December 1997. The European Commission has presented an amended proposal for a directive on the taxation of savings income in July 2001 and has now entered into negotiations with key third countries in order to ensure that equivalent measures are taken there. Progress is also being made in the field of corporate income taxation. The Code of Conduct for business taxation should lead to the progressive roll back of 66 harmful tax measures in this field.

Fighting Financing for Terrorism

Specific action against terrorist financing has increasingly come into focus. Several measures have been taken following UN Security Council Resolution 1333 to freeze assets of targeted persons and organisations associated with the Taliban. In addition, parallel work at the FATF and among supervisors has started as well as the strengthening of provisions used to combat money laundering. While no claim can be made that such measures will eliminate terrorist financing, they have led to increased co-operation between relevant authorities and additional pressure on illicit financing circuits.

Although money laundering and the financing of terrorist activities have some features in common, they are substantially different in nature. While the first one involves laundering illegally obtained money (hence disguising its origin), the other represents almost the inverse i.e. the processing of funds, often from legitimate origins, to be used for future crimes. A further complication is that completely legal donors can fund terrorist groups through perfectly legitimate-looking charity donations that could ultimately end up in the hands of terrorists. Thus legitimate money can finance activity which might be illegal but the intention in respect of the donor cannot be established.

With respect to fighting financing for terrorism, the Council adopted in March 2001, on the basis of a Council Common Position[81], Regulation 467/2001[82] strengthening measures in

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80 OECD (2001d).

81 Common Position 2001/154/CFSP of 26 February concerning additional restrictive measures against the Taliban (OJ L57, 27.2.2001, p.1).

respect of the Taliban of Afghanistan on the basis of UN Security Council Resolution 1333. The applicable lists of entities and individuals, the accounts of which were frozen in the EU, included the Al-Qaida organisation and Usama Bin Laden as well as nine other associates. The Regulation was amended several times to reflect a consolidated list of persons and entities, established by the UN Taliban Sanctions Committee, to whom the freeze of funds would apply.

Misuse of Corporate Entities

The prevention of the misuse of corporate vehicles[83] for illicit purposes is seen as an important element of a successful strategy to curb the abuses of the international financial system.[84] While the diversity of corporate entities, comprising corporations, trusts, foundations and partnerships with limited liability features, is a well-established feature of the global economic system, some corporate vehicles are set up mainly to conceal the identity of the owners and/or beneficiaries of such entities. They can thus be misused for illicit purposes, including money laundering, the circumvention of disclosure requirements, bribery and corruption, hiding and shielding assets from creditors and supporting unlawful tax practices[85].

Proposals to combat the unlawful use of corporate structures stress the need to enhance their transparency. In particular, several mechanisms are proposed to obtain the necessary information on beneficial ownership and corporate control[86]. The first approach would be to introduce disclosure requirements about the beneficial owners and the control structure upon the establishment of a new corporate entity as well as each time the corporate structure is modified. A second approach would rely on intermediaries as the main source to supply the desired information. Such intermediaries would include formation agents, trust companies, and lawyers etc. involved in the formation and management of corporate vehicles. The third approach would operate through investigative measures such as court subpoenas and house searches. Depending on the conditions and traditions prevailing in different jurisdictions, the three mechanisms could be combined to re-enforce their effectiveness.

In addition to increasing the transparency of corporate structures, the OECD recommends ensuring that appropriate and sufficiently integrated oversight capacities are in place. Moreover, non-public information on beneficial owners and corporate control should be shared with other relevant supervisors and law enforcement authorities, both domestically and internationally, for the purpose of investigating illicit activities, fulfilling their supervisory functions and facilitating compliance with the requirements embodied in anti-money laundering laws, such as customer identification.

Towards Better Co-ordination

Some have claimed that the international fight against abuses would benefit from a more co-ordinated approach. One option would be to set up new international institutions to cope with

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82 Council Regulation (EC) No 467/2001 of 6 March 2001 prohibiting the export of certain goods and services to Afghanistan, strengthening the flight ban and extending the freeze of funds and other financial resources in respect of the Taliban of Afghanistan, and repealing Regulation (EC) No. 337/2000 (OJ L 67, 9.3.2001, p.1).

83 The OECD (2001) in its report on the misuse of coporate entities for illicit purposes defines corporate vehicles as « legal entities through which a wide variety of commercial acitivities are conducted and assets are held. »

84 Financial Stability Forum (2000) and G7 Finance Ministers (2000b).

85 OECD (2001e).

86 OECD (2001e).

these matters. In that view, global problems, such as in the tax and financial fields, are better dealt with at the global level and using "global" instruments. Also, in a truly international forum, developing countries - which have arguably suffered as much as any country from the effects of financial abuses- would have a greater voice, as of course would many of the financial and tax havens and off-shore centres. In this way, the perception of a "rich man's club" ganging up on smaller, and in some cases poorer, countries would be overcome. However, it should be underlined that most tax and financial havens are relatively well-off countries, while the adverse consequences of unfair practices are borne by both developed and developing countries.

An alternative would be to work with existing institutions and ensure better co-ordination of regional and international organisations. Existing institutions such as the FATF or the OECD have already obtained considerable results; a number of jurisdictions are now moving towards fairer practices in the financial and tax fields as a result of their work. If a new organisation were to assume the lead in areas such as harmful tax competition, there is a strong risk of losing much of the momentum already achieved and positive results, such as commitments by a number of jurisdictions to remove harmful features of their tax regimes, could be put in jeopardy. Furthermore, it is also possible that harmful criteria and the remedies could be made much weaker than at present due to the mere participation of tax and financial havens in the decision-taking of the new institution. Lastly, it is unlikely that creating new organisations would overcome the aforementioned legitimacy problems. Indeed, such organisations would require both a wide country membership to give their proposals legitimacy and either the ability to reach a consensus or some other means of enforcing the majority view. Complex decision-taking processes may ultimately lead to unsatisfactory results from the point of view of both developed and developing countries.

C.3. Regional and Global Co-operation

This section discusses initiatives to enhance the stability of the international monetary system by intensified macro-economic co-ordination within the context of regional groupings and among the G3.

Regional Macro-Economic and Monetary Co-operation

Regional macroeconomic and monetary co-operation have been advocated as a way forward to spur regional economic integration and making small and relatively open economies more resilient to external disturbances[87]. While for large economies, such as the US, Japan and the euro area, the repercussions of large swings in exchange rates on the real economy tend to be moderate, for emerging market economies and developing countries the impact can be significant. They may thus have a particularly strong interest in an exchange rate system that ensures a maximum level of stability.

However, the Asian crisis has underlined that the globalisation of financial markets and the high level of international capital mobility are rendering the policy requirements for maintaining pegged exchange rates more demanding. It is often argued that for open emerging market economies, floating exchange rates are the most viable solution.[88] There is, however, universal recognition that any viable exchange rate policy needs to be consistent with and backed up by domestic economic and financial policies.

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[87] For example Frankel and Rose (1996) and Rose (2000).

[88] Mussa et al. (2001).

Dornbusch (2001) stresses the importance of regional financial market integration. He argues that as capital markets are broadening and deepening in response to progressing integration, the exchange rate becomes less important as an instrument of adjustment in the case of a negative shock. The capital market would be able to take over an important part of the buffer functions typically assigned to exchange rates.

This line of reasoning is consistent with the European experience. European Economic and Monetary Union has created a pole of monetary and financial stability for Europe fuelling further market integration and growth dynamics. Enhanced macroeconomic and exchange rate co-operation among the Members of the European Community has complemented and reinforced the Internal Market project to generate growth and stability for the European Union. The experience of financial turbulence and strong intra-European exchange rate swings in the beginning of the 1990s have enhanced the commitment to move ahead with monetary union. The modest impact on EU financial markets of the 11 September attacks indicate that Member States with their move to a single currency have successfully reduced the vulnerability of their economies to external financial turbulence.

While the EU situation cannot be translated to other regions without qualification, the experience of the European Community on its way to Economic and Monetary Union provides a good benchmark to analyse the sequencing and the necessary conditions of successful regional monetary co-operation. Essential ingredients include policy co-ordination on the basis of a shared philosophy on fiscal discipline; shared views on price stability; and some form of institutionalised multilateral monitoring. Given the free movement of capital and the desire to stabilise the exchange rate between Member States, the convergence of monetary policy rules is inevitable.

Bearing in mind the lessons from the Asian crisis, the Asian economies in the context of the Manila Framework and the Chiang Mai initiative have made some progress in enhancing financial and monetary co-operation in the region[89]. Some argue that it could be beneficial for East Asian emerging market economies, particularly ASEAN countries, to move towards a regional system of managed exchange rates. In order to stabilise the system in the beginning, appropriate measures to curb excessive capital flows could be envisaged. Over time, however, as the system would become more robust, these restrictions could be removed to ensure the development of a functioning capital market in the region.[90]

In the Americas, the approach to monetary co-operation appears to be less systematic. Monetary co-ordination is not included in the framework establishing the North American Free Trade Agreement. The US, Canada and Mexico operate exchange rate regimes of free floating with different degrees of de fact management. Within Mercosur, a wide range of exchange rate regimes exist. While Brazil has adopted a system of free float, Ecuador and El Salvador, and until recently Argentina, chose a currency board or have decided to unilaterally adopt the US dollar as their home currency. This raises questions whether the existence of different exchange rate regimes is compatible with the objective of regional economic integration.

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[89] The Manila Framework sets the ground for regional financial and monetary surveillance and foresees co-operative financial arrangements for participating countries in times of financial crisis. Members include Asian and non-Asian countries, such as the U.S. The Chiang Mai Initiative is designed to expand existing swap arrangement among ASEAN countries, China, Japan and the Republic of Korea.

[90] See Kuroda (2001).

For regions with a dominant regional economy such as the euro area for Europe and the US for North America, it has been claimed that improved monetary co-operation and progressing currency consolidation on the periphery can deliver important systemic gains. Some authors suggest that NAFTA provides a good argument for closer co-operation between the US, Canada and Mexico. Dornbusch (2001) argues that particularly the latter could benefit from permanently pegging its currency to the US-dollar via the introduction of a currency board. With the prospect of fewer crises on the periphery, improved regional stability and growth potential, the centre, therefore should take an active interest if not leadership in promoting regional monetary co-operation.[91]

Macroeconomic Policy Co-operation among the G3

The economic developments of the three major currency areas have substantial repercussions on the world economy as a whole. Against the background of growing economic and financial interdependence, and the increased potential for more sudden and deeper spill-over of shocks, a number of proposals have been made to enhance macroeconomic and particularly exchange rate policy co-ordination among the G3.[92]

Most proposals advocate the creation of a target zone for bilateral (nominal) exchange rates. As unilateral targeting tends to be less effective than mutual action, a G3 target zone would typically require a trilateral agreement on bilateral target rates; a mutual understanding about who is doing what in case of the observed exchange rate moving away from the agreed target rate as well as about the margins beyond which action is required. Target zone proposals can thus vary regarding the size of the band and the rules for intervention (with or without inter-marginal intervention, symmetric or asymmetric intervention etc.).

The mechanism proposed by Wolf (1999) is less ambitious by comparison. He proposes for the euro area and Japan to unilaterally define a ceiling on their respective bilateral exchange rates vis à vis the dollar. In that scenario, the ECB and the Bank of Japan would conduct monetary policy in such a way as to ensure that the respective bilateral exchange rates would not exceed a certain threshold. This proposal was motivated by the view that the appreciation of the bilateral euro/dollar and the yen/dollar rates above desirable levels was more likely than a depreciation to undesired levels and that the risks associated with a possible overvaluation of the euro and the yen are bigger than the risks associated with a weakening of both currencies. In contrast with the concept of a target band, Wolf's proposal is an asymmetric approach, which could be effective for the euro area and Japan to avoid that their exchange rates rise to levels considered unhealthy for their respective economies. However, it provides no rule in case of swings in the opposite direction.

The design for a new global exchange rate system advocated by Mundell (2001) is the most ambitious. Given the high degree of inflation convergence among the major currency areas, he argues that some sort of monetary union of the G3, that is a single world currency, is feasible and desirable. This would require, a common inflation target, a joint rule for monetary policy and agreement on the distribution of seigniorage. Mundell's proposal has triggered an ongoing academic debate about the desirability of a single world currency. In addition to the economic arguments raised against fixed exchange rates, Rogoff (2001)

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[91] See Portes (2001) and Dornbusch (2001). Concerning the euro the ECB (1999), p. 45, does not share these conclusions and reports that the Eurosystem has adopted "…a neutral stance, neither hindering nor fostering the international use of its currency."

[92] For example Volcker (1995), Williamson (1986), McKinnon, R. (1997), Wolf (1999) and Mundell (2001). For a survey of some of the proposals see Clarida (1999).

identifies a number of fundamental reasons against a global currency unification, including: (i) no adequate checks and balances on the global central bank due to the absence of a global government; (ii) international decision making could make it difficult to agree on appointing central bankers who place a strong weight on price stability; (iii) global currency competition provides a check on inflation.

In general, proponents of an engineered stabilisation of exchange rates argue that the targeting of exchange rates among the G3 currencies would increase the overall stability of the international monetary and finance system, implying fewer crises and higher growth for both the major currency areas as well as the emerging market economies and developing countries. The cost for international transactions would diminish, boosting economic integration. For economies located at the periphery of the major currency areas, it would become less risky to peg their currency to one or to a basket of key currencies. In some cases, countries would be expected to give up their home currency altogether to be substituted by one of the major currencies.

However, empirical evidence seems to suggest that for the G3 the repercussions of exchange rate swings on trade and investment are much slower and less pronounced than one would expect by looking at the extent of changes implied in variations of bilateral nominal exchange rates[93]. In addition, under fixed exchange rate systems, monetary policy authorities lose to a significant degree the ability to react independently to external shocks and domestic policy priorities. This can imply significant welfare losses in case of asymmetric shocks.[94] Obstfeld and Rogoff (2000) argue that "continued improvement of monetary policy institutions at the domestic level, coupled with the further broadening of world capital markets, may render efforts towards closer exchange rate co-ordination superfluous or even counterproductive."

Moreover, some claim that under a regime of fixed exchange rates, monetary policy itself can become a genuine source of policy shocks. [95] With free capital movements, G3 authorities have to use domestic monetary policy as a tool to stabilise exchange rates. As a result, the variability of interest rates and monetary induced changes in domestic income and demand may rise. Against this background, the benefits for emerging market economies from stabilising exchange rates between the G3 countries are therefore not clear cut. While under a system of target zones, the relative prices for emerging market economies may become more stable as G3 exchange rates become more predictable, the increased variability of interest rates and G3 income may increase uncertainties for emerging market economies related to external financing and external demand. The welfare effect for an emerging market economy of a G3 target zone depends on how this zone is designed and on the particularities of the small country's output, trading partners and debt structure. To the extent that an emerging market economy is vulnerable to high and volatile world interest rates, the consequences of the trade-off implied by a G3 target may be considerable.

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93 See Rogoff (2001). Contrary to the link between volatility and trade, Sekkat (1997) reports that there is a consensus in the economic literature on the negative impact of exchange rate misalignment on trade.

94 The relevance and magnitude of this effect depends on various factors, such as the degree of economic integration and correlation of macroeconomic conditions. Advocates of target zones, such as Bergsten and Henning (1996) argue also that a) adjustment to shocks should be dealt with by the real economy, b) target bands leave some room for independent monetary policy and c) that if necessary revisions of the target rate are not excluded.

95 Reinhart and Reinhart (2001).

C.4. Towards Improved Governance

The IMF has until now remained the institution where the formal decision power related to the international monetary and financial system is vested. The substantial increase in its membership has transformed it into a global institution and the broadening scope of IMF tasks have been accommodated without substantial changes in the institutional setting or the decision process. The relative quota share of the founding members, mainly industrial countries, has reduced but advanced countries continue to retain a comfortable majority in voting power, with the US still enjoying a de facto veto with respect to major decisions[96]. New members were added to existing constituencies chaired by one of the founding members or, if the new member was economically important like Russia, China, and Switzerland, were allowed to form new constituencies through a gradual increase in the number of Executive Directors and Members of the International Monetary and Financial Committee to 24.

The calls for more legitimacy, more accountability, and better governance for the Fund take place in the context of growing concerns of emerging market economies about the continued predominance of advanced countries in the IMF decision process and in informal fora with limited membership, such as the G7. They go in parallel with requests from NGOs and national parliaments for increased accountability since the IMF is also perceived by some as an excessively technocratic and not-transparent institution.

Various proposals have been made to address these concerns. Some of them have been partly or fully implemented, others lack sufficient political support. The complexity of the issues and the conflicting objectives explain why so far changes in this area have been relatively limited. More recent changes and proposals include:

- **The creation, outside the IMF, of groups such as the FSF (see section C.2.) and the G20**. The G20 was created in September 1999 as an informal mechanism for dialogue among 20 major industrialised and emerging market economies. While both fora serve a useful purpose, increasing the number of informal groups risks adding to the confusion and ultimately complicating the decision process since these fora lack legitimacy and non-participants do not feel involved.

- **Increasing the transparency of the decision process**. The IMF has made efforts to publish its Board proceedings and to explain its decisions to the public. Transparency has, however, its limits: difficult decisions may require a certain degree of confidential dialogue before being taken. Moreover, NGOs and national parliaments not only want transparency but also wish to be in a position to influence decisions taken by the IMF. It is not entirely clear whether indeed the legitimacy of decisions taken by the Fund would be increased if the Fund's operations were taken on the basis of other than 'objective' criteria or if the Fund would be accountable to more groups. Furthermore, making the Fund accountable to anything else but its membership (as is now the case through the Board of Governors) seems a rather unworkable principle. Whereas having for instance national parliaments endorse decisions would probably help to increase legitimacy, it would most likely bring the operations of the institution to a halt.

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[96] Major decisions are taken by a majority of 85 percent of the total voting power.

- **Transforming the IMFC into a Council with decision power**[97]. This would have the advantage of giving more political weight to the IMF and increasing accountability by leaving important decisions to be taken by Ministers, rather than by the Executive Board. The creation of the permanent IMFC, replacing the Interim Committee is a step in this direction. Creating a Council would transform the IMF into a much more political institution. It would also risk complicating the relations between the Board and the Council.

- **Re-balancing the decision power within the Fund**. Various avenues have been suggested, including changing the quota formulas or increasing the number of basic votes. Progress on that front is conditional upon the recognition that calls for a more balanced involvement of emerging market economies are legitimate and should be supported.

- **Clarifying relations between the IMF and the World Bank**. Though there is a widely acknowledged need for improved co-operation and clearer division of labour between the Fund and the World Bank and other development agencies, proposals to that end differ substantially. Some would like to separate more clearly IMF and World Bank functions (Meltzer Commission). This would translate into shifting concessional or development financing by the Fund to the World Bank and by having the IMF focus narrowly on its monetary and crisis role. However, others stress that the IMF is a quasi global institution that should assist all its members. It also has a unique expertise in designing sound and consistent macro-economic policies and in putting in place the key elements for a global growth strategy. Without financial support to these countries, the IMF would have no leverage. Again others would like to see a merger of some IMF and World Bank departments to deal with development issues. Practical arrangements risk, however, being quite complex.

- **Creating new overarching bodies**, such as a Global Governance Group or a UN Economic Security Council. In a recent report on global governance Camdessus and others[98] recommend to complement the current G7/8 mechanism by a high-level **Global Governance Group (3G)**. This group would include the 24 Heads of State and Government that have Executive Directors in the Boards of the IMF and the World Bank. In their view, this would balance the double objective of efficiency in decision making and maximum representativity, as all countries would be represented either directly – the five countries holding the largest share of quotas – or within the established framework of regional constituencies. The 3G would monitor trends and policy developments in the field of global economic, social and environmental issues, and assure coherence, co-ordination and arbitration among the major international organisations. Like in similar proposals, annual meetings at Head of State level would decide on key issues of strategic concern, such as the creation of new institutions. 3G Summits would be jointly prepared by a network of Sherpas and the staff of the UN, the Bretton Woods institutions, the WTO, the ILO and the to be established World Environment Organisation. The Heads of these institutions would participate in the meetings.

[97] As suggested in 1998 by Minister Strauss-Kahn.
[98] COMECE ad-hoc Group on Global Governance (2001).

A variety of sources have advocated the creation of **a UN Economic Security Council (ESC)**[99]. As with the 3G, the purpose of such a Council would be to provide leadership on global economic, social and environmental issues; in contrast with the previous proposal it would be established under the auspices of the UN by complementing the Security Council. The Council would continuously assess the state of the world economy and the interaction between the major policy areas; provide a long-term strategic policy framework in order to promote stable, balanced and sustainable development; and secure consistency between the policy goals of the major international organisations, particularly the Bretton Woods institutions and the WTO, while recognising their distinct roles.

Proponents of an ESC argue that it could enhance the authority of the IMF and the World Bank and make their work more effective, by providing guidance, which is based on conclusions of a more representative body than the Group of Seven. The Council would have no legally binding power, but would act as a steering group for global governance and provide leadership through the quality of argument and the authority derived from its membership. Membership would be limited to some 23 members. It would include the largest economies (in terms of GDP measured in purchasing power parity) and be open to representatives of significant regional organisations such as the European Union and ASEAN. Meetings would be held once a year at the level of Heads and more frequently at the level of ministers of finance and/or economics and trade. A constituency system, rotation and consultation mechanisms are envisaged to ensure that the broader membership of the UN is represented in the decision making of the ESC. Moreover, the relationship between the General Assembly and the ESC would need to be defined.

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[99] See, for instance, the Commission on Global Governance (2001), www.cgg.ch. Initiated by the former chairs of various UN related commissions on development, the Commission on Global Governance was established in 1992 comprising of 24 members, including former heads of government, international organisations, and ministers. They serve in their personal capacity. Ingvar Carlsson, former prime minister of Sweden, and Shriddath Ramphal, former secretary-general of the Commonwealth, are chairing the Commission.

CHAPTER III : PROMOTING AND FINANCING DEVELOPMENT

The benefits of globalisation have not been shared by all, and more remains to be done for the poorest countries to avoid further exclusion and marginalisation. As outlined in Chapter one, even though in the past decade the share of the population living on less than one dollar a day has actually decreased to 24%, the number of people below the poverty line has remained at around 1.2 billion, with an additional 1.6 billion living on less than 2 dollars.

The failure of poor countries to "catch up" has been attributed to poverty trap conditions of subsistence income, low savings and investment, low levels of education and high fertility. A related argument comes from those who stress that poor people remain poor or get poorer not because of globalisation, but because they are excluded from it. The logical response would be more openness to the world economy; however, as economic liberalisation may not necessarily promote equality convergence, accompanying policies are as important.

In terms of development policy, it has become clear that measures in developing countries that strengthen economic growth alone are not enough. There is now a growing consensus that increased emphasis has to be put on poverty reduction, which should be the primary objective of development co-operation. This has been reflected in the Millennium Declaration of the UN General Assembly.[100] It has also been recognised that measures should not be imposed from outside, but should be based on a participatory process.

In addition, while for a long time the UN, World Bank and IMF were seen as offering different perspectives on development, these differences have now narrowed with the World Bank embracing the basic principles of social development and the UN giving more attention to macro-economic discipline and open markets.

The concept of poverty has changed over the years. There is now agreement that poverty goes beyond the lack of income and financial resources, and includes non-monetary factors such as the lack of access to education, health, natural resources, employment, land and credit, political participation, services and infrastructures. These elements are seen as essential to allow people to take control of their own development, enjoy equality of opportunity, and live in a safer environment.

The upcoming UN Financing for Development conference scheduled for March 2002 in Monterrey has focused the discussions on how best to achieve the overall objective of poverty reduction. Most of the issues at stake have been raised in the so-called Zedillo Report (United Nations (2001b)) commissioned to a High-level Panel by the UN Secretary-General Kofi Annan in December 2000. It focuses on the mobilisation of domestic and foreign resources (be it foreign direct investment or ODA), promotion of international trade, and sustainable debt financing.

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[100] The Declaration spells out the following eight *Millennium Development Goals*: eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases; ensure environmental sustainability; develop a Global Partnership for Development. On the need for specific and quantifiable development goals, see also the 1996 Report of the Development Assistance Committee (DAC), the principal body through which the OECD deals with issues related to co-operation with developing countries.

Many of these elements will be touched upon in this chapter. A first part assesses the various existing instruments contributing to development processes and reduction of inequalities, such as ODA, debt reduction, market access and foreign direct investment, and looks at ways to improve their effectiveness for poverty reduction. The second part reviews various alternatives for financing for development, including fiscal mechanisms at the international level.

A. Assessment of Existing Instruments

A.1. ODA

Official Development Assistance (ODA) is defined by the OECD as the sum of grants and concessional loans (i.e. with a grant element of at least 25%) undertaken by the official sector and with the primary objective of promotion of economic development. The measurement of ODA is, however, not straightforward. World Bank experts criticise it on three accounts[101]: under-estimation of aid content due to netting out[102], misrepresentation of the correct level of concessionality (the loans are fully counted, even if the grant element may only be at 25%) and on the calculation of the grant element itself. Another criticism derives from the observation that donor countries have brought over the past two decades a variety of public expenditures under the heading of ODA, such as the cost of development administration, education costs for students from developing countries, emergency and disaster aid and cancellation of debts[103]. Calculations of ODA flows between 1990 and 1994 would have been 35 to 42% lower, had the original definition been strictly applied.

A.1.1. Trends in ODA and the 0.7% Target

On the whole, trends in ODA have been disappointing. While total long-term capital flows to developing countries increased from $ 98 billion in 1990 to over US$ 295 billion in 2000, ODA stayed at US$ 53 billion over the same period (Table 2).[104]

Table 2 : Net Long-term Flows to Developing Countries, 1990-2000

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Total (billion $)	98.5	123	155.8	220.4	223.7	261.2	311.2	342.6	334.9	264.5	295.8
Official flows	*56.8%*	*49.5%*	*36.3%*	*24.3%*	*21.5%*	*21.1%*	*10.3%*	*12.5%*	*16.3%*	*17.1%*	*13.0%*
Private flows of which:	*43.2%*	*50.5%*	*63.7%*	*75.7%*	*78.5%*	*78.9%*	*89.7%*	*87.5%*	*83.7%*	*82.9%*	*87.0%*
Debt flows	36.9%	30.3%	38.4%	29.5%	28.7%	30.6%	35.3%	32.4%	31.4%	-0.3%	12.2%
Equity flows	6.6%	12.2%	14.2%	30.6%	20.0%	17.5%	17.6%	10.1%	5.6%	15.7%	18.6%
FDI	56.6%	57.5%	47.4%	39.9%	51.2%	51.9%	47.1%	57.6%	63.1%	84.6%	69.2%

Source: World Bank (2001a).

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101 Chang *et al.* (1999).

102 By netting out amortisation payments, the net flow of ODA, i.e. disbursements minus amortisation, underestimates the aid content of flows. As an example, a constant flow of identical highly concessional loans would represent a continuous cost for the donor but would lead to a zero net ODA flow, as amortisation flows would exactly match aid flows.

103 Mertens (2001).

104 OECD (2002).

In terms of percentage of DAC members'[105] GNP, the share of ODA decreased from 0.33% in 1990 to 0.22% in 2000 (back to the level of 1997),[106] and hence further away from the recommended aid target of 0.7%. According to the 2001 DAC report, only five OECD members (Denmark, Luxembourg, Netherlands, Norway and Sweden) have reached in 2000 the level of 0.7% GNP to be spent on ODA (figure 9), while the EU on average has reached 0.33%.

The origin of the 0.7% target dates back to the 1969 Pearson Report[107], where it was calculated that a resource transfer of 1% of GNP would allow the 6% growth in developing countries judged necessary to lift them from aid-dependency. With private capital flows estimated in 1969 at 0.3%, official flows would have to bridge the gap of 0.7%. At the time, it seemed to be an ambitious yet achievable goal. In reality, if in 1968 ODA level as a percentage of GNP was 0.48%, in the early 1970s it fell dramatically to between 0.30 and 0.35% (probably also due to the oil-crisis), and it remained stable for twenty years. At the beginning of the 1990s, the end of the Cold War brought new hopes of a "peace dividend" from reduced military expenditures that could be used for development assistance, which were however not fulfilled as pointed out above. This may be linked to the recession of 1992-93 and the donors' efforts to bring their own budgets back into balance, but it also reflects the donors' willingness to ensure an effective use of existing ODA resources before increasing the volume further (OECD (2000)).

Over the years, all DAC members, except Switzerland and the United States, have accepted the 0.7% target, even if the degree of commitment has varied widely from firmly agreed budget allocations and target dates to more general statements. At the European Council of June 2001 in Göteborg, the EU committed to reach the UN target as soon as possible and is currently looking to have a clear road map for setting out the way it intends to reach these financing goals[108].

As far as non-EU donors are concerned, despite the reduction of its aid, Japan remains in 2000 the leading country in providing bilateral ODA (USD 13 billion), with the United States the second largest provider (about USD 10 billion). The role of non-DAC members (former-CMEA and Arab countries) peaked in the mid-70s, when they made available 30% of total ODA, while nowadays 95% of ODA is provided by DAC members. Figures for the CMEA were rather difficult to estimate though, as aid was often in kind at unpublished prices; moreover, aid from China was not included. More recently, new OECD donors are emerging such as Korea, Turkey, and three Eastern European countries (the Czech Republic, Hungary and Poland).

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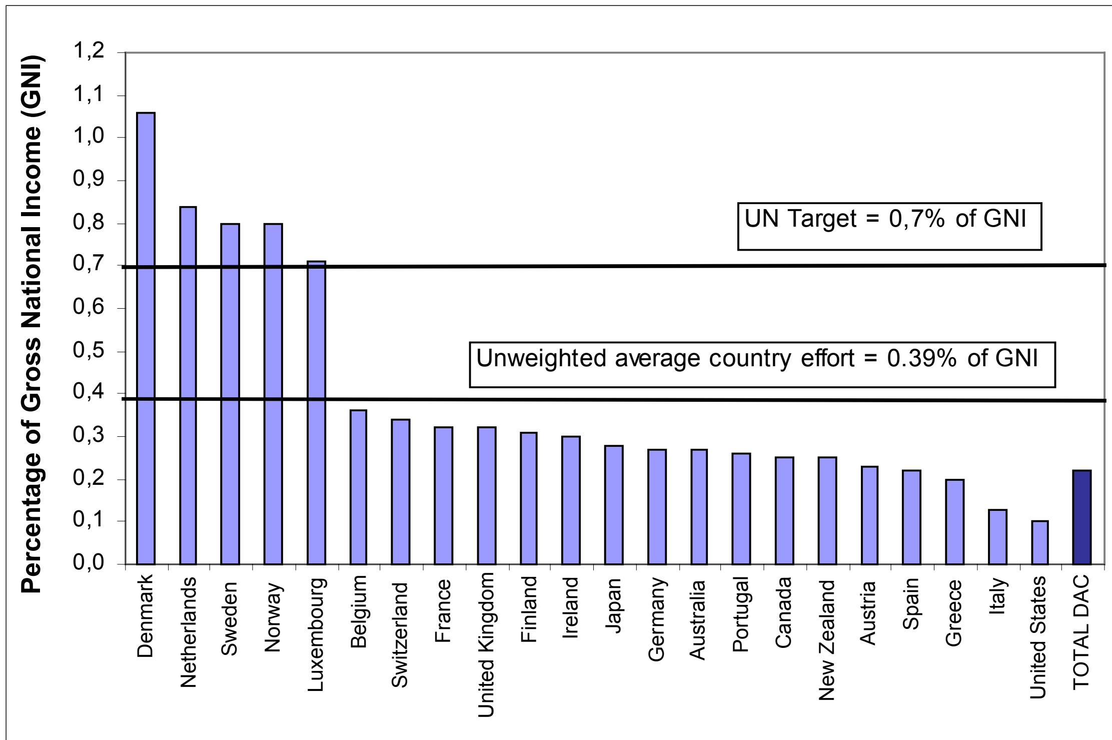
105 The 23 members of the Development Assistance Committee (DAC) of the OECD are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States, as well as the Commission of the European Communities.

106 For comparison, in 1999 the ODA relative to all developing countries' GDP was 0.6%, compared to 1.4% in 1990 (UNDP (2001)); this decline is also evident for the LDCs, who saw their percentage fall from 11.6% to 7%, over the same period.

107 Pearson (1969).

108 See also conclusions of the Development Council of Ministers in November 2001.

Figure 9: Net ODA in 2000 – in % of GNI



Source: OECD (2002)

Apart from the amount of ODA provided to developing countries as a group, it is also worth looking at the destination of ODA. Most of European donors focus on sub-Saharan Africa, whereas other donors (Australia, Canada, Japan, New Zealand, the United States, but also Germany and Spain) focus more on the Pacific region (Asia, Latin America, and Pacific). This regional orientation results in a higher proportion of aid being allocated by these donors to middle-income than is the case for most of the EU donors (OECD (2002)). Overall, two thirds of ODA flows (close to $40 billion) go to 88 developing countries that appear to be "on track" to halve poverty by 2015 compared to 1990 levels (one of the development goals endorsed by the UN General Assembly). The remainder goes to 55 developing countries, mostly LDCs, that are struggling to reach the international development goals and for which more aid would make a substantial difference**.** Recent World Bank estimates[109] show that, irrespective of the 0.7% overall target, current levels of ODA would need to be doubled in order to help low-income countries to reach their 2015 development goals.

The *European Union* is one of the major actors in international development co-operation. Whereas the European Commission and the EU member states together provide about 50% of world aid, the EC alone provides some 10% of the entire world aid. Its aid programme has continued to grow over a period during which many other donors' programmes have declined. The total share of European aid managed by the Commission has gradually increased from 7% thirty years ago to 17% today.

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[109] IMF and World Bank (2001b).

Starting from a programme that originally included mainly Africa and few more countries in the Pacific and Caribbean (ACP countries), the EC has become global in its reach. New agreements, which go far beyond the traditional development aid, have been signed to cover Asian and Latin America developing countries (ALA programme), for the implementation of the Euro-Mediterranean Partnership (MEDA programme), for the co-operation with the Central and Eastern European Countries and the New Independent States since 1990 (PHARE and TACIS programmes), and more recently specifically for the Western Balkans (CARDS) .

EC external aid has also become more varied in nature. The vast bulk (some 90%) of EC aid is grant aid, with less than 10% provided as concessional loans. Hard loans, such as some European Investment Bank lending have also been provided, but these are not included in the EC aid budget. Exceptionally, macro-financial assistance has been provided which took most often the form of loans but increasingly also a combination of grants and loans. Under the former Lomé Convention the traditional forms of assistance to ACP countries (financial and technical co-operation) were joined by new aid instruments such as STABEX (system to stabilise export earnings) and SYSMIN (the special facility for the mining sector). The new Cotonou Agreement signed in June 2000 recognises the vulnerability resulting from high dependence on export earnings from the sectors of agriculture and/or mining and foresees additional support in case of serious falls in export earnings. In the new system, vulnerable ACP countries will be assisted in the framework of the overall programming process and in accordance with the country's development strategy priorities.

Over the past decades, the number of major donors has increased, and the number of bilateral and multilateral agencies and non-governmental organisations have increased even more. According to the World Bank (2000), in the 1960s five donors – France, Germany, Japan, the United Kingdom, and the United States accounted for some 90 % of donor assistance, whose combined share declined to less than 70% but was delivered through a greater number of agencies. This development, on top of the absolute and relative decline in ODA is obviously a problem for recipient countries and calls for donor co-ordination, specialisation and concentration.

The World Bank and the IMF are two main players among multilateral institutions, providing support to implementation of the development agenda of beneficiary countries. Regional development banks (BAD, ADB, IDB, EBRD) co-ordinate closely their development assistance instruments with these two institutions. In terms of concessional flows by multilateral organisations over the period 1994-1998, IDA (World Bank group) accounted for an average 33%, the IMF for nearly 5%, the UN agencies system for 17%, with the European Commission accounting for 31%. Concessional arms of regional development banks (Inter-American Development Bank, Asian Development Bank and African Development Bank) accounted together for 11% of total flows.

A.1.2. Improving Effectiveness and the Quality of Aid

The discussion on volume of aid has been paralleled by a discussion on the effectiveness of aid.

The 1998 World Bank's *Assessing Aid* report, based on a series of econometric studies[110], showed that aid boosts economic growth and alleviates poverty only in those countries that

110 Burnside and Dollar (1997) and Collier and Dollar (1999).

carry out sound economic policies and has no measurable effect in countries with poor policies. Sound policies include open trade regimes, fiscal discipline and avoidance of high inflation. The report concluded that a reallocation of aid to "good policy-high poverty" countries would increase the efficiency of assistance.

Other studies have qualified these results. The economic model underlying the World Bank study is found to be rather sensitive to the choice of the variables.[111] Also, aid can have a positive impact on economic growth in countries with a poor policy environment as long as the aid to GDP ratio is not high.[112] It has also been claimed that cutting off poor performers from aid allocation may not always improve overall aid effectiveness. Where poor performance is caused by external shocks (e.g. terms of trade changes), continued assistance may prevent the country from entering a lasting recession.[113] Lastly, uncertainty in aid flows (deviations from expected inflows) may have a negative impact on the level of investment in a country, which is in itself a principal determinant of growth. When such uncertainty is controlled for, aid may have a positive effect on growth even in a poor policy environment.[114]

Conditionality and Ownership

Most aid programs are conditional upon the implementation of certain policy reforms. However, it is increasingly accepted that the effectiveness of aid requires a national commitment to the reform process and that economic reforms can be supported but "cannot be bought". This implies that the conditionality associated with adjustment lending is unlikely to stimulate reforms unless it is in line with the Government's own programme.

The criticism of conditionality dates back to the early 1980s and stemmed from the fact that the results of the structural lending were disappointing and in some cases even were perceived as harmful to economic growth.[115] The initial reaction of the donor community was to increase the number of conditions and to shorten the period for the execution of programmes so as to stimulate developing countries to carry out the required reforms. However, recipient governments were unwilling to carry out these reforms because the conditions were perceived as inappropriate or as imposed without their direct involvement.

The perceived failure of conditionality led to a new emphasis on ownership of the reform process by the recipient country's government. The Comprehensive Development Framework (CDF) was introduced by the World Bank in October 1998, and launched in January 1999, as a concept for a holistic approach to development. The CDF seeks a better balance in policy-making by highlighting the interdependence of all elements of development: social, structural, human, governance, environmental, economic, and financial. It promotes partnerships among governments, development co-operation agencies, civil society, and the private sector. Of particular importance is the emphasis on country ownership of the development process. Within this framework, the World Bank and the IMF subsequently launched in September 1999 the Poverty Reduction Strategies (PRS) for low-income countries, to mainstream poverty reduction in Government and donor policies, in particular in those recipient countries that benefit from enhanced debt relief within the HIPC initiative. In support of the PRS of IDA eligible countries, the World Bank has developed the Poverty Reduction Strategy Credit

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[111] Dalgaard and Hansen (2000).
[112] Hansen and Tarp (2000).
[113] Guillaumont and Chauvet (2000).
[114] Lensink and Morrissey (2000).
[115] Killick (1998).

(PRSC) and the IMF Poverty Reduction and Growth Facility (PRGF) arrangements, successor to the ESAF. [116]

The European Commission has also shifted from traditional policy-based conditionality towards results-based assessments and related aid disbursements. The new orientations in macro-economic support therefore aim at increasing long-term sustainability of economic and social reforms, fostering government's ownership of the programme and enhancing donor co-ordination. The degree of implementation of the new approach varies among countries, according to the degree of achievements in developing well-articulated and coherent PRSP documents and establishing key performance-based indicators, as well as the availability and quality of data, the institutional capacity for their collection and assessments and the existence of a framework for improving public finance management to ensure that budget funds – government and donor alike – are properly spent and have maximum impact. The pilot exercise on the reform of conditionality carried out in Burkina Faso has been a key element for the Commission to set up these orientations.

At the same time, the Commission has launched a fundamental reform of its external assistance, aiming to improve aid quality, cut implementation time, harmonise and simplify aid management. In particular, the Commission has undertaken to strengthen the programming process to ensure the consistency of strategies defined for all the developing countries and introducing a process of deconcentration and decentralisation intended to bring decision-making closer to partner countries.[117]

Policy Coherence

Promoting coherence between development policies and those of trade, security, investment, and the environment continues to be a major challenge for international donors. Incoherence is often caused by conflicting interests (e.g., geopolitical concerns, economic interests, solidarity) among the multiplicity of actors involved in development at international level. Incoherence is also created at the national level within the agencies of donor governments because of the plurality of decision-making bodies. Furthermore, in the past years there has been a proliferation of items on the development agenda. Development does no longer include only economic growth and elimination of poverty, but also gender equity, environmental sustainability, good governance, and respect of human rights.

Within the OECD Development Assistance Committee (DAC), efforts are being made to promote policy coherence for development. For example, the DAC and the Trade Committee will undertake a "common reading" of the Doha Trade Ministerial outcome and, together, assess its implications and directions for future collaborative work on the development dimension of trade. Also, the DAC Development Partnerships Forum brings together different OECD policy communities, developing country and private sector stakeholders to discuss how to attract private finance in the development process. These examples illustrate the "two-way street" approach to promoting policy coherence, which goes beyond integrating the development dimension in the work of other policy communities, but also looks to integrate the policy findings of those communities into DAC work.

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[116] Apart from greater ownership and poverty reduction focus, fiscal targets are more flexible, conditionality is more selective and there is more emphasis on measures to improve public resource management, transparency and accountability.

[117] See European Commission (2001)

The Treaty on European Union contains several references to policy coherence. The aim is that consistency of EU external activities as a whole be ensured in the context of its external relations, security, economic and development policies. The Council, Commission and Parliament all bear responsibility for increasing the level of coherence of policies that have or may have a bearing on the Union's external performance. Ideally the different EC and also Member States' policies should fit together, complement each other, and create positive synergetic effects. As a minimum, it should be ensured that these policies, and the activities implemented in the context of these policies, do not contradict or work against each other. The challenges are well-known – including the effects of trade, agriculture and fisheries policies on developing countries - and have been part of the development policy discourse for many years, and the efforts to integrate trade in development policy are an example of the pursuit of policy coherence.

Untying of Aid

One of the most extensively discussed cases of policy incoherence is tied aid. The question is whether aid should be freely available to buy goods and services from all countries (untied aid) or whether aid should be restricted to the procurement of goods and services from the donor countries (tied aid). One of the rationales of tied aid is to 'buy political support' for development policy at home, by benefiting domestic companies through public procurement.

In May 2001, donors have reached an agreement on a DAC Recommendation to untie ODA to the least developed countries.[118] The Recommendation also acknowledges that different approaches are required for different categories of ODA and that actions to implement the Recommendation might vary among donors in terms of coverage and timing. It should be noted that the recommendation only concerns the LDCs, which may not have the full supply capacity of public procurement; also, the recommendation does not cover technical co-operation, nor food aid.

The EU has accepted to implement the DAC Recommendation on the untying of aid to LDCs and several Member States are in the process of untying their bilateral aid beyond the scope of the recommendation. The Community has identified the measures necessary to implement the recommendation and will set in motion the necessary procedures. The Commission's intention is to go further, with the support of Member States, e.g. though the revision of the ALA regulation, and to prepare a communication that would propose implementing the DAC recommendation through all its aid instruments. That would, in the case of the Cotonou Agreement, also require the consent of the ACP partners.

Co-ordination and Complementarity

The fragmentation of aid and poor co-ordination has been a major obstacle to aid effectiveness. If better policy performance in recipient countries is important, likewise donors should do more to ensure the effectiveness of aid. The inefficiency that arises from lack of donor co-ordination is an old, but still unresolved problem. Some attribute this lack of co-ordination to the recipients' lack of absorptive capacity, others to the different objectives that drive donor programmes and again others to the multiplicity of aid agencies, each pursuing their own priorities.[119]

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[118] DAC Recommendation on Untying Official Development Assistance to Least Developed Countries, OECD, May 2001.

[119] Cassen et al. (1994), Alesina and Dollar (1998) and Kanbur and Sandler (1999).

All donors recognise the importance of partnership to address development more effectively. From the start of 2000, country-led poverty reduction strategies (in the light of the World Bank's Common Development Framework) have provided a common ground for improving donor action at the country level in many of the poorest countries. At the sectoral level, the focus has been on harmonisation of operational policies and procedures in and between multilateral and bilateral agencies, which should eventually contribute to a decrease in the transaction costs of international ODA. Despite talk of better harmonisation, practice lags behind. An important immediate step is the sector-wide approach, by which financing is provided to an investment programme for a selected sector in its entirety, based on an evaluation of that sector's policy framework and institutional strengths. Although progress has so far been limited, an important learning process is ongoing (World Bank (2001a)).

As far as the EU is concerned, the Treaty establishes that the Community and the Member States shall co-ordinate their development co-operation policies and consult each other on their aid programmes, including in international organisations and during international conferences. Strengthening complementarity and moving towards a division of labour between the Community and the Member States is one of the principles agreed in the new policy framework adopted by the Council and the Commission. The concentration of Community activities in a more limited number of areas where it can make a special contribution and can have an added value to that of other development partners, and in particular the EU Member States, is fully consistent with this approach. The Council and the Commission have identified the following six priority areas: link between trade and development; support for regional integration and co-operation; support for macroeconomic policies and promotion of an equal access to social services (education and health); transport; food security and sustainable rural development; institutional capacity-building, particularly in the area of good governance and the rule of law.

Concessionality

There is an on-going discussion on increasing the share of development funding in the form of grants rather than concessional loans, as a way to better target poverty reduction and to prevent accumulation of unsustainable debt burdens.

This also affects IDA, the concessional arm of World Bank lending, which is currently discussing its 13th replenishment[120]. Various alternatives are being assessed for the possible introduction of grants into IDA-schemes[121]. These range from providing up to 50% of IDA resources in the form of straight grants for IDA-only countries (i.e. equivalent to 40% of all IDA 13 funds), to limiting to 5-10% such expansion of grants. Also, a possible differentiation within IDA-only countries is considered, with very poor countries being given the highest level of concessionality, as well as post-conflict/post-disasters countries.

While the introduction of grants could change the nature of IDA, and thus raise fundamental questions, it also has implications in terms of financing. Given that loan repayments from IDA credits contribute for around 40% to IDA replenishment, the introduction of grants will involve a cost in terms of foregone re-flows. This entails that either more resources from donors would be needed, or more grants to poorer countries would result in hardening terms for less poor IDA borrowers. These on-going discussions have also led to explore other routes

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[120] IDA donors get together every three years to discuss IDA replenishments; the current IDA 13 concerns fiscal years 2002-2005.

[121] "Grants in IDA", IDA, September 2001, available on http://www.worldbank.org/ida/ida13docs.html.

for providing increased concessionality, such as extended maturities, the abolition of the service charge in concessional loans (currently at 0.75% of disbursed balances), and the extension of the grace period.

A.2. Debt Reduction

The debt of developing countries continuously increased until the mid-1990s despite repeated debt relief actions provided by official and private creditors. This accumulation of debt not only prevented the debtors to face their repayment obligations but also further hampered their development.

According to the debt overhang theory[122], excessive debt burdens divert resources from key productive investments and discourage policy reforms which could promote growth. They constrain the ability of indebted states to finance basic expenditure, e.g. in the areas of education and health. This is particularly true for highly indebted poor countries, which need to target expenditures towards poverty reduction.

Debt relief lowers the budgetary resources tied up in debt servicing and, if accompanied by the right economic policies, should contribute to creating a more stable macro-economic environment with lower interest and inflation rates conducive to saving, investment and sustainable growth. It should also allow the country to increase budgetary spending in social sectors, assuming that debt relief is not accompanied by a reduction in ODA. Through a reduction of the debt burden to a sustainable level, domestic and foreign private investment is likely to increase, as potential investors will be less concerned about higher taxes (including inflation) which could be imposed in the future to pay off the debt.[123] The reduction will also increase the chances that the portion of the debt that remains outstanding will be repaid, which is beneficial for the creditor (and may in some cases even outweigh the cost of debt reduction). Finally, debt relief may improve the quality of the dialogue between the donors and the beneficiary countries, as it will refocus the discussion on priorities and reduce the preoccupation with the terms of refinancing the old loans.

A.2.1. Trends and Figures

Following a sharp rise in the 1970s which multiplied the debt stock by a factor of 8, the overall stock of external public debt of developing countries continued to rise, from US$ 377 billion in 1980 (at the beginning of the debt crisis) to more than US$ 1600 billion in 1998. It decreased slightly in 1999 and 2000 (Table 3).

Table 3: External Public Debt of Developing Countries, in billion US$

	1970	1980	1990	1995	1996	1997	1998	1999	2000
Multilateral (incl. IMF)	8	61	242	356	345	353	420	424	410
Bilateral	26	127	397	566	543	529	527	533	512
Private	14	189	510	588	569	609	676	665	669
Total	**48**	**377**	**1149**	**1510**	**1457**	**1490**	**1623**	**1621**	**1591**

Source: World Bank, Global Development Finance

122 See e.g. Claessens et al., (1996).
123 World Bank, (2001a).

At the same time, the debt of the 42 heavily indebted poor countries (HIPCs) increased from about US$ 60 billion in 1981 to more than US$ 180 billion in 1995, and declined somewhat afterwards to about US$ 170 billion in 1999. Relative to GNP, the debt of developing countries doubled from 18% in 1981 to 37% in 2000. Over the same period of time, the debt to GNP ratio of HIPCs rose from about 50% in 1981 to a level of 110% in 1999, having peaked at more than 160% in 1994.

According to Daseking and Powell (1999), factors contributing to the substantial rise in external debt in the 1970s and the 1980s included adverse terms of trade shocks, a lack of sustained adjustment, structurally weak debt management practices and political factors. They also emphasise "national interest" lending which suggests that, from the creditor government perspective, the motivation for a significant share of commercial lending or guaranteeing of loans to low income countries was the stimulation of their own exports.

For developing countries in general, private creditors have been the largest creditor group over the last 20 years (followed by bilateral and multilateral creditors), even if their share decreased from about 50% in the 1980's to slightly more than 40% in 2000. For the HIPCs, bilaterals have always been the largest creditors, followed by the multilaterals and, far behind, private creditors. For the group of 24 HIPCs benefiting from interim debt relief, the multilaterals have become the main creditors, with a share of 40% of total debt outstanding in 2000. Claessens et al. (1996) underlined that creditors of the HIPCs are mainly official creditors (bilateral and multilateral) rather than private commercial creditors and that their *primary* objective was not profit maximisation, but that they had a set of more complex goals. It was therefore argued that the conventional approach for analysing debt issues needed to be adjusted to the specificities of these countries.

A.2.2. Debt Reduction Mechanisms

Where several players are involved (which is usually the case), debtors and creditors have generally found it preferable to reschedule debt in a concerted framework (Abrego and Ross (2001)). Such concerted action addresses the free-rider problem according to which creditors may try to avoid providing debt relief but would nevertheless profit from improved debt servicing capacity of a debtor country, once debt relief has been granted by others (see also Claessens et al.). This free-rider problem applies both within creditor groups (e.g. between different official creditors) and between different creditor groups (e.g. official versus private creditors). Another advantage of concerted action is that the negotiated agreement is generally based on a common framework and a common set of conditions, such as those defined in the context of an IMF programme. Such a framework increases substantially the likelihood that the debt relief will have a lasting positive impact on development.[124]

Paris Club

The Paris Club of official creditors[125] provides a framework for rescheduling, on a case-by-case approach, of sovereign-to-sovereign debt (publicly owed or guaranteed, with medium- and long-term maturities). Fulfilment of IMF conditionality and consensus between creditors are *sine qua non* conditions for reaching a debt relief agreement. Until 1987, Paris Club rescheduling involved mainly cash flow relief, which contributed to a continuous rise in debt. Creditors believed that the debt service problems of the poor countries would only be

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[124] Daseking and Powell (1999).

[125] The Paris Club, which was active for the first time in 1956, includes nineteen permanent members countries.

temporary. While private creditors had typically reduced their exposure in these countries and cut their losses in response to their customers' payment difficulties, official creditors provided comprehensive non-concessional flow rescheduling in the context of the Paris Club under the so-called 'classic terms'.

In the second half of the eighties, it became clear that low income countries (LICs) were facing solvency problems that required not only a temporary debt relief, but also a reduction in the level of debt. In 1988, the Toronto G-7 summit adopted a compromise, leading to a reduction of one third of the NPV of the LICs outstanding debt, including for the first time commercial export credit agency debt. The Toronto terms were granted to 20 LICs by the Paris Club until 1991.[126] They were subsequently replaced successively by other terms with increasing NPV reductions,[127] ending with the Cologne terms in 1999 providing a 90% reduction- or more if necessary - in the context of the Enhanced HIPC initiative (Cologne terms).

HIPC Initiative and Enhanced HIPC Initiative

The HIPC initiative, launched in 1996, started to deal with the debt burden owed to multilateral institutions, rather than merely concentrating on bilateral debt.[128] Its principal objective is to bring the poorest countries' debt burden to sustainable levels, subject to satisfactory policy performance, so as to ensure that adjustment and reform efforts are not put at risk by continued high debt and debt service burdens. It has been underlined repeatedly, however, that the achievement of this goal will depend on whether or not funding used by the donor countries to finance the debt relief is obtained by cutting other forms of aid.

Soon after the approval of the original HIPC initiative, doubts were expressed by NGOs and academic circles whether the debt relief envisaged was far-reaching enough. Criticism not only focused on the extent of debt relief and the targeted sustainability level (with obvious implications for the number of countries supported under the initiative) but it also questioned the wisdom of waiting until the completion point before debt relief is granted. This condition aimed to create a satisfactory track record to increase the chances that the debt reduction would have the desired positive effects on development and also aimed to address the moral hazard problem.[129]

In 1999, following pressure from NGOs and the development community, the HIPC initiative was enhanced to provide "deeper, broader and faster" debt relief to those countries pursuing

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[126] As far as the (highly-indebted) lower middle-income countries are concerned, the Paris Club creditors began in 1990 to grant them concessional debt reduction (for ODA only) in the form of flow rescheduling (Houston terms).

[127] From 1991 London terms (up to 50% reduction of the NPV of the LICs outstanding debt); from 1994 Naples terms (up to 67% on both ODA and non-ODA credits to HIPCs); from 1996 Lyon terms (up to 80% of NPV debt reduction to countries qualifying for the HIPC initiative).

[128] The HIPC Debt Initiative is open to the poorest countries, those that: (i) are eligible only for highly concessional assistance such as from the World Bank's International Development Association (IDA) and the IMF's Poverty Reduction and Growth Facility (PRGF); (ii) face an unsustainable debt situation even after the full application of traditional debt relief mechanisms (including Paris Club agreements); and (iii) have a proven track record in implementing strategies focused on reducing poverty and building the foundation for sustainable economic growth.
Under the enhanced framework, a country's debt is deemed unsustainable if the ratio of the net present value of external debt to export exceeds 150% (see http://www.worldbank.org/hipc for more details).

[129] Providing debt relief to those that are running bad policies while not supporting those that have been able to avoid a debt problem through serious adjustment and cautious borrowing practices may induce policy-makers to opt for the wrong policies (see e.g. Claessens et al.)

reform and poverty reduction.[130] One of the major challenges, from the creditors point of view, has been to find the necessary resources to finance the increase in the costs resulting from the enhancement of the HIPC initiative. In order to finance the participation of the multilateral institutions in the initiative, a Trust Fund, managed by the World Bank, was established.

Out of the 42 identified HIPCs, 24 countries have so far reached the decision point - when the debt relief is approved and interim relief begins - and 4 countries have reached the completion point – when the remaining amount of relief is committed irrevocably[131].

The EU has been a major player in the HIPC initiative. The Community, as a creditor[132], has so far decided to contribute to the HIPC initiative for a total amount of € 360 million (40 under the original and 320 under the enhanced initiative, all in favour of ACP countries). As a donor, the Community will contribute to the enhanced initiative for a total amount of € 734 million (680 for ACP countries, 54 for non-ACP countries).[133] As far as the implementation is concerned, the Community has already transferred € 304 million to the HIPC Trust Fund managed by the World Bank.[134] As a creditor, there have been some delays in implementation, essentially due to the Commission's internal reform and delays by recipient countries to respond to proposals of action. So far, the Community has provided grants for debt alleviation in favour of Uganda, Guyana, Burkina Faso and Mozambique, totalling about € 38 million.

London Club – Brady Plan

As far as private creditors are concerned, the London Club provides a framework allowing debtor countries to restructure their debts owed to commercial banks, which is required by the Paris Club under the "comparable treatment" clause.[135] Unlike the Paris Club, where the agreement with the debtor has to be unanimously approved, the negotiated agreement within the London Club needs approval of banks holding 90 to 95% of total exposure. Since there is no legal possibility to force dissident creditors to accept the negotiated agreement, and given the usually large number of creditors concerned, a minority of them can delay the process for years.[136] Results of negotiations may vary from debt rollover to significant write-down.

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130 *Deeper* means that the relief would cut deeper into the debt by lowering the target sustainability ratios in order to ensure a permanent exit from the debt problem. *Faster* means that the so-called completion point under which full debt relief can be delivered can be reached earlier than the normal 6-year period of performance required under the original IMF/WB supported programs and during which countries had to implement a wide range of reforms in a satisfactory way. These modifications also resulted in the expected debt relief being *broader* by expanding the likely number of countries becoming eligible.

131 Under the original framework, six countries (Uganda, Bolivia, Burkina Faso, Guyana, Mali and Mozambique) had already reached their decision and completion points.

132 The outstanding claims that the Community has on the HIPC's concern mainly the so called special loans, which were granted to the ACP countries in the 1970's and 1980's, and risk capital loans managed by the EIB.

133 Council Decision 98/453/EC of 6 July 1998 and ACP-EC Council of Ministers Decision 1/1999 of 8 December 1999.

134 € 10 million dedicated to Guyana (the sole non-African ACP country), € 240 million dedicated to African ACP countries, and € 54 million dedicated to Asian and Latin American countries.

135 Given that there are generally more creditor commercial banks than creditor governments, a committee of about 15 banks is generally designated by the London Club to negotiate with the debtor. An active IMF agreement is a prerequisite for such negotiations.

136 Radelet (1999).

The Brady Plan launched in 1989 offered creditor commercial banks the choice between providing new money or accepting a debt stock. The commercial banks generally chose the second option, where the principal and some of the interest of loans would be guaranteed with US Treasury bonds in exchange for a write-down of the amounts outstanding. Although the Brady Plan has benefited 15 middle income countries and no poor countries, the experience may contain useful lessons for other countries, such as the importance of implementing macroeconomic stabilisation and economic reforms prior to debt reduction (Claessens et al.(1996)).

A.2.3. Continued Debate

Whereas there seems to be a consensus that the enhanced HIPC debt relief is an improvement compared to the original initiative and earlier actions, there is an ongoing debate on whether the current action of creditors is sufficient to address the problems of the poorest countries.

Impact and additionality

According to recent analysis, the cumulative debt reduction provided by the Paris Club and multilaterals to the group of 24 HIPCs having already reached their decision point should attain 64% (expressed in 1999 NPV terms), which sounds impressive.[137] In NPV terms, this is expected to deliver US$ 20.3 billion, including US$ 10.6 billion provided by multilateral creditors, while all HIPCs are expected to be granted a total of US 29.3 billion.

However, Cohen (2000) argues that the type of calculations made above grossly overstate the benefits for the recipient country implied by the debt reduction. He estimates the average price of HIPC debt to be at 28%, but the marginal value of the debt (indicating the degree to which they will actually benefit from a certain amount of debt reduction) at only 10%. While recognising that the enhanced HIPC initiative "is clearly more generous, as it reduces the debt down to a point where the effect can be felt", he calls for more *transparency* (through reporting losses of about 90% and the granting of actual debt relief for the remaining part). He argues that donor countries would as a result be less tempted to scale down ODA in line with debt relief and more inclined to respect the principle of *additionality*, which is necessary to ensure that the debt initiative has an overall positive impact on the country concerned. The concern about additionality is more generally shared (see also World Bank (2001a), Jubilee+ (2001), Eurodad (2001a)).

Debt Sustainability and the Poverty Link

It has been questioned whether the HIPC initiative will indeed ensure debt sustainability. The General Accounting Office of the US Congress (2000) as well as a number of NGOs[138] have argued that the calculated debt sustainability levels are still too high. The difficulty of basing debt relief on highly volatile export earnings (determined among other things, by world growth, terms of trade and market access) has been addressed, at least partially, by the recent agreement by the International Monetary and Financial Committee that from now on each HIPCs debt sustainability is assessed at its completion point. This allows for the possibility of providing additional debt relief for those countries for which the debt situation has worsened due to exceptional factors which include bad growth performance and deteriorating terms of trade.

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137 World Bank (2001c).
138 Jubilee +2000, Eurodad.

Others question whether the debt-to-export ratio is the appropriate criterion to judge sustainability. For example, Cohen (2000) presents econometric results that suggest that the debt-to-tax ratio would be a more appropriate primary indicator for assessing debt sustainability than the debt-to-export ratio. Sachs (1999) argues that the debt-to-export ratio ignores the fact that "debts were owed by governments, not exporters", and that the ratio of debt to exports could conceivably measure the trade-offs between debt servicing and meeting basic human needs. He proposes that the cost of basic social needs and a government's capacity to pay have to be better taken into account, adding that the net resource transfers of highly concessional assistance have to be increased to finance the budget rather than off-budgetary programmes.[139]

NGOs argue along similar lines, underlining that even the enhanced HIPC initiative is not sufficiently contributing to poverty reduction.[140] They suggest to base the assessment of debt sustainability on poverty reduction: budgetary resources would be reserved, in a first stage, for expenditures which are necessary to fight poverty (such as education, health and basic infrastructure); in a second stage, to service the domestic debt; and only in a third stage to service the external debt. The size of the poverty-reducing expenditures would be derived from the country-owned PRSPs.

From this perspective, any low-income country that suffers from high level indebtedness coupled with low government revenues and widespread poverty would be eligible for a debt relief initiative. But by putting debt repayment as the last priority of expenditures, the beneficiary countries might have more difficulties in gaining investor confidence and financial market access. Moreover, this proposal raises the important issue of the availability and the programming of resources to finance the debt relief as well as the moral hazard issue.

In this context, it is also worth mentioning that according to the World Bank, social expenditures in the 24 enhanced decision point countries are estimated to have increased by an average of US$ 1.7 billion during 2001-2002.[141] At the same time, it is worth noting that systems that track the execution of overall spending on poverty related programmes need to be further developed.

Irrespective of other ongoing debates, it is generally recognised that the beneficiary countries have a very important responsibility in pursuing the right policies, in the framework of a well designed PRSP which will determine the future trend of economic growth and new external borrowing and therefore ultimately its long-term debt sustainability. The balance between conditionality (track record of good policies) on the one hand and poverty focus and immediate relief on the other has been shifted towards the latter through the Enhanced HIPC initiative, but not all would agree that this shift has been sufficient.

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[139] At the same time, he advocates a cancellation of debt servicing on old debts. According to Sachs, debts owed to bilateral creditors, IBRD and IMF should be forgiven, while IDA would need to be only forgiven in case IDA debt servicing was imposing large net resource costs on a particular country.

[140] Eurodad (2001a).

[141] World Bank (2001c).

In this context, it is important to note that several creditor countries have decided to cancel the total of their eligible claims towards HIPC countries. Also, at the initiative of the Commission, the Council decided in May 2001 to alleviate all special loans granted to least developed ACP HIPCs that would remain after the full implementation of the enhanced HIPC initiative. This decision, which has been endorsed by the Joint EU/ACP Ministerial Council, would lead to a further € 60 million debt relief.

Is the HIPC Initiative Reaching a Sufficient Number of Countries?

The question whether the HIPC initiative is making a sufficient impact on the world debt and development situation is not only raised with regard to those countries that are expecting to receive debt relief under present mechanisms, but also regarding those that may not benefit under current circumstances.

A first group to consider is the countries in conflict which are in principle eligible for the HIPC initiative but have not qualified yet. Out of the 14 countries which have so far not yet benefited from debt reduction in the context of the HIPC initiative, 9 countries are considered as conflict- affected. There is a common understanding on the need to facilitate HIPCs emerging from conflict crisis to qualify for debt relief and the initiative has been taken by the G-7 to reinforce the political dialogue with these countries. On the other hand, it is difficult to conceive fast-tracking of debt relief for regimes engaged in acts of aggression or internal repression.[142]

A second consideration is to review whether it may be possible to make more countries than the 42 HIPCs qualify for HIPC or other debt relief. This issue has received new impetus following the 11 September events which have raised the question to what extent impoverished countries provide a breeding ground for terrorism. One possibility may be that in the light of the latest events and the slowdown of growth more countries may qualify for this or other debt relief. The other option would, of course, be a review of the level and nature of the eligibility criteria which is linked to the sustainability discussion referred to above.

The Financing Issue

Obviously any idea to provide deeper or broader debt relief meets with very important financing constraints. It was already difficult to mobilise the financing for the Enhanced HIPC initiative (especially for multilaterals such as the African Development Bank). Moreover, there is a possibility that the recent slowdown in growth and the decision to make an analysis at the completion point could imply further costs. On the other hand, there seems to be some consensus that the current debt situation of developing countries is not only the result of bad policies in those countries. Against this background, any examination of this question will obviously have to weigh, in a comprehensive and forward-looking way, the global costs of a possible perpetuation of the debt problem against the costs of providing additional relief (which would obviously have to also be addressed in a comprehensive way).

A.3. Integration into the Global Trade System

Efforts to integrate developing countries into the global trade system and other development-oriented policies, in particular ODA should be seen as complementary aspects of an overall strategy towards sustainable global development, and more specifically targeting economic

[142] See also Group of Seven (2001a).

growth and poverty reduction. Several studies have shown that there are links between trade, development and poverty reduction.

Firstly, there is an acknowledged positive relationship between trade and economic growth.[143] Secondly, there seems to be a positive relationship between growth and reduced levels of poverty. Growth tends to benefit all sectors of society 'raising all boats' and thereby bringing the poor above the poverty line. There is clear evidence of such an effect in East Asia, where six out of ten were living on under $1 a day in the mid-70s, while today it is two out of ten, and where, beyond conventional economic indicators, other indices of development such as literacy, life expectancy, and levels of political liberty have also shown an upward trend.

Establishing a direct link between trade and poverty reduction is more complex. Several studies have found an empirical positive relationship between trade openness, growth and poverty reduction.[144] However, others have questioned the robustness of such studies, particularly the appropriateness of the indicators used for openness (Rodrik (2000)). These criticisms highlight the difficulty in proving the empirical link conclusively through cross-country empirical analysis in a context where so many other factors are at work. In addition, they indicate the importance of adopting sound economic policies and flanking measures to help ensure that the economic and development benefits of trade openness can be realised.

Moreover, there is some evidence that the poorest sections of the population may be the most vulnerable to short-term restructuring costs of trade opening, particularly terms-of-trade changes or higher volatility.[145] Increased openness may also reduce the capacity of protecting strategic industries, as well as increase the risk of anti-competitive behaviour by large foreign companies.[146] These potential negative effects must be anticipated and appropriate policies adopted in tandem with liberalisation if the positive impacts of openness are to be felt throughout the population.

Although there is extensive debate on the extent to which openness stimulates poverty reduction, there is less controversy on the fact that it has a role. Few economists would now argue that closed economies foster growth and, indeed, there are no examples of closed economies that have shown sustained rapid growth. Therefore, it appears that trade openness is a necessary, but not sufficient, condition for growth and poverty reduction, as well as being to some degree an outcome of them. To ensure a positive impact, additional policies, including sound social and economic policies, regulatory frameworks conducive to trade and investment and adequate re-distributive and retraining policies are required.

In many developing countries, domestic reform and increased trade liberalisation will not be adequate to ensure extensive increases in exports. Trade-related technical assistance and capacity-building are important tools to help countries make use of the opportunities for trade-based growth. Many countries simply lack the administrative capacity to fulfil the various requirements (e.g. health and safety standards, rules of origin, intellectual property rights protection) for market access, preferential or MFN (Most Favoured Nation) based.

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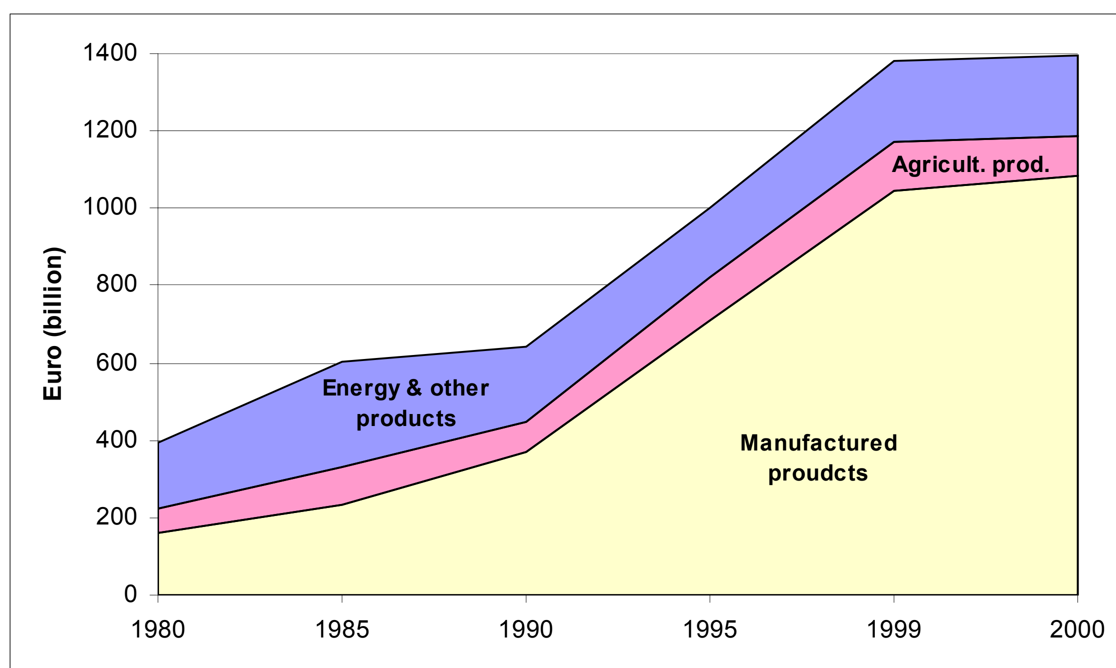
143 Dollar (1992), Sachs and Warner (1995), Edwards (1997).
144 e.g. Dollar and Kraay (2001).
145 Lundberg and Squire (1999).
146 McCulloch et al. (2001).

A.3.1. Trends in Trade

If oil trade is excluded (where exports have fallen significantly in dollar terms) developing countries have made significant gains in recent years and are thus, at a general level, more integrated into the world economy (see figure 10). In the past decade the share of developing countries in global non-energy exports rose by almost 7%, reaching 25% in 1999, while their share remained stable at around 39% in total exports including energy (World Bank (2002a)). This rise was mainly due to manufactured goods, whose share of developing countries' exports increased from 25% in the early 80's to 70% in 1999. Developing countries are in particular exploiting their comparative advantage in labour intensive manufactures. Their share of world trade in these sectors rose over ten percentage points in the 1990's to 53%.

One should, however, observe that these favourable tendencies are highly concentrated in the emerging market economies such as Mexico, Chile, Brazil, China, Taiwan China, Malaysia and Thailand. Virtually all the least developed countries are not part of this trend.

Figure 10: Developing Countries' Exports by Sector (Euro billion)

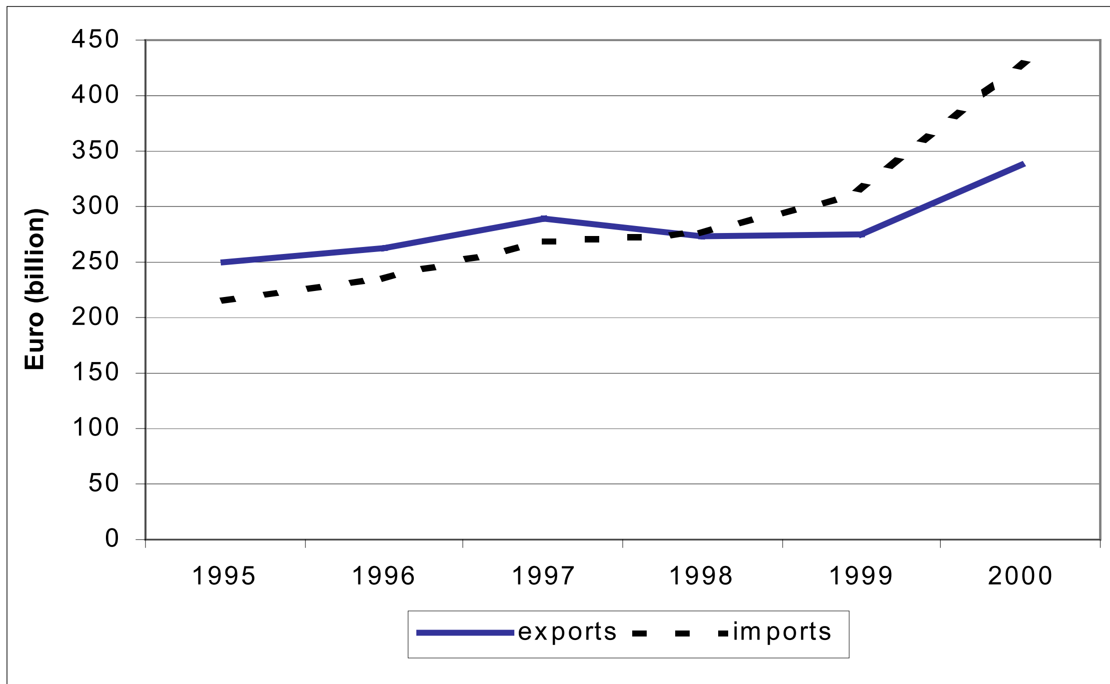


Source: UN Comtrade database

Exports to the EU have shown strong growth. The EU is the main trading partner for much of the developing world: more than half of developing countries exports to the Triad[147] go to the EU, with which developing countries as a group are now in surplus (figure 11). In 2000, developing countries accounted for 42% of extra-EU imports.

[147] Triad refers to the three largest trading powers; i.e., the EU, the US and Japan.

Figure 11: EU Trade with Developing Countries (Euro billion)



Source: Comext Database, Eurostat.

A.3.2. The Challenges of Integration

The main tools for fully integrating developing countries into the global trade system and thereby enabling sustainable development, are trade liberalisation, trade related capacity building and accompanying policies. Each of the three aspects requires action at international and domestic levels, by developed and developing countries alike.

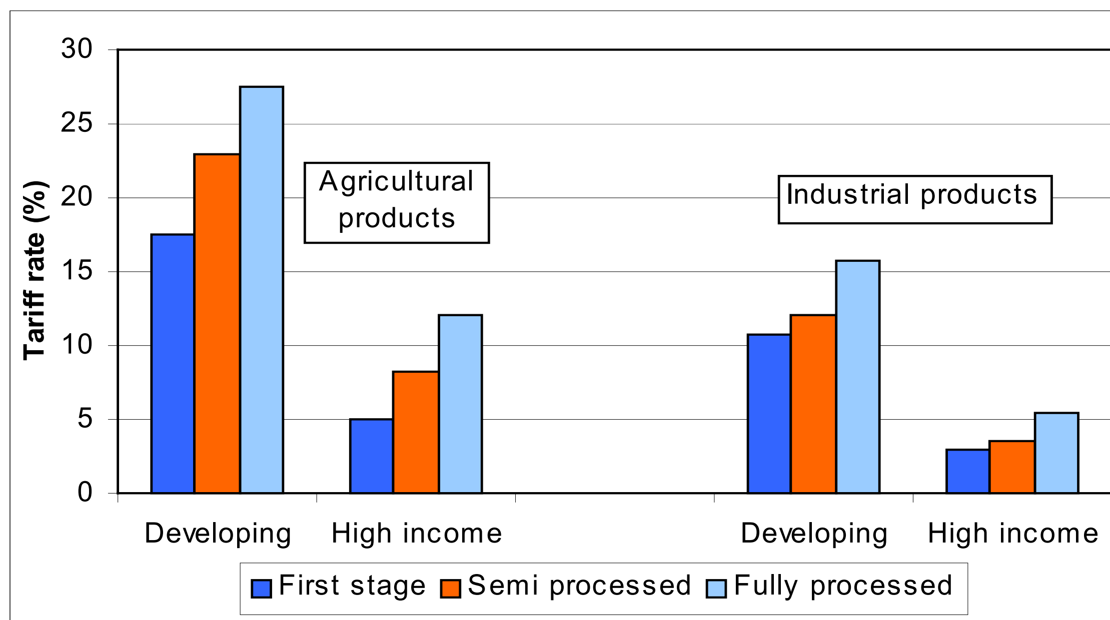
Trade liberalisation

Improved market access has the potential to bring major welfare gains, especially to the developing world. A recent study by the World Bank (2001a) considered the impact of full trade liberalisation (an admittedly unlikely immediate prospect) and concluded that developing countries would see increases in welfare of up to US$ 539 billion per year if dynamic impacts on productivity are taken into account. A major part of this gain is due to reductions in developing countries' own protective tariffs. This lowers import prices for consumers and for producers using imported intermediate goods and encourages the re-allocation of domestic resources towards production in sectors in which developing countries have a comparative advantage.

Developing countries' exports still tend to be disadvantaged as regards market access, at least if one regards MFN tariff rates only. Their tradable output often has a high component of agricultural and labour-intensive manufacturing goods (such as textiles). These goods often face the highest trade barriers in developed country markets as well as in neighbouring regions. The World Bank has calculated that exports of agricultural and labour intensive manufactures face tariffs of, on average, twice the level of other goods. Figure 12 shows that

the highest rates are still in developing countries, but developed countries also practice tariff escalation[148].

Figure 12: Tariff Escalation



Source: World Bank (2001b)

Reducing tariff peaks and tariff escalation is therefore important to increased market access. In the case of non-agricultural products, this is indeed an agreed objective for the trade negotiations in the WTO that were launched at the 4th WTO Ministerial Conference in Doha in November 2001. Developing and developed country high tariffs should be addressed in this context. In fact most of the welfare gains forecast by the World Bank come from the elimination of tariffs between developing countries, rather than improved access to developed markets.

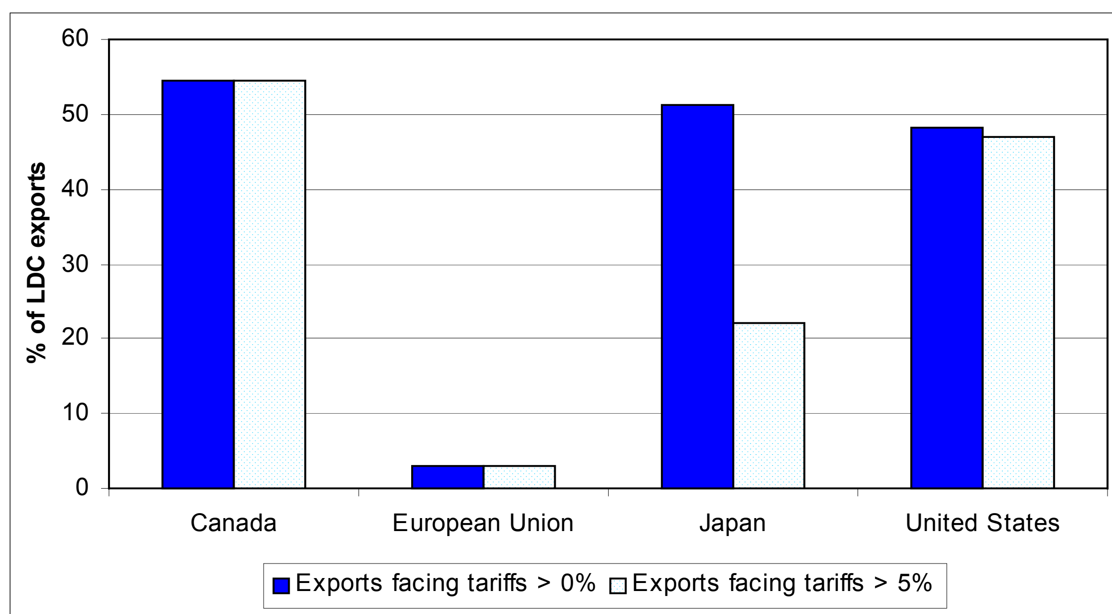
The impact of tariff peaks and tariff escalation in developed country markets is to a large extent offset by preferential access, such as, for the EU, the GSP scheme, bilateral free trade agreements or the EU-ACP Cotonou Agreement. The Generalised System of Preferences (GSP) provides preferential access to the EU market to beneficiary countries and therefore enhances their export earnings, promotes their industrialisation and encourages the diversification of their economies. However, if beneficiary countries were better equipped to meet procedural and technical requirements (e.g. sanitary and phytosanitary standards, customs and transport procedures, etc.) they could increase their utilisation rate and compete more efficiently on international markets. The new EU GSP Regulation, adopted in December 2001, for the period 2002-2004, further simplifies the rules and harmonises procedures making the instrument more user-friendly and effective. The unilateral EU 'Everything But Arms' (EBA) initiative launched in early 2001 opened EU markets to all LDC exports, by

[148] Tariff escalation signifies that higher tariffs are applied to processed goods than to corresponding primary goods.

allowing duty and quota free access. This market access should enable them to exploit economies of scale to develop industries which were previously unviable[149].

At the May 2001 3rd UN Conference on LDCs, all industrialised countries for the first time committed to the objective of duty and quota free access for all exports originating in LDCs. Such an emulation of the EU EBA by other major industrialised nations would contribute significantly to LDCs' opportunities for trade based growth [150]. Studies of the impact of EBA have forecast large increases in welfare as a result – between US$ 400 and US$ 317 million depending on the study.[151] However, even prior to the adoption of EBA, levels of protection against LDC exports were far higher in other QUAD[152] countries than in the EU (figure 13). Thus if all Quad members were to adopt similar measures, the welfare impact would be much higher (US$1.8 bn-2.5bn).

Figure 13: Pattern of Protection Facing LDC Exports (pre-EBA)



An equally important element for development is the liberalisation of trade in services. In contrast to removing or lowering tariffs at the border, this encourages and requires policy reform. Furthermore, restrictions on trade in services do not increase government revenues in the form of tariffs but raise the costs for consumers thus affecting the economy at large. In other words, increasing efficiency in the services sector would have direct welfare effects by reducing costs of services for consumers and governments alike. However, it should be borne in mind that effective services liberalisation (e.g. telecommunications liberalisation) may involve costs to the domestic government in the form of establishing effective regulatory agencies.

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[149] As the EBA only concerns LDCs which often have a very small productive capacity, with a very weak exporting base, the overall effectiveness of the EBA on poverty reduction may be limited.

[150] The EU was the major destination for LDCs' exports even before EBA was adopted. In 1998, the EU accounted for 56% of their total exports. Moreover, the EU already had very low tariffs for LDC imports; exports of the main products liberalized by EBA were, however, very low. Eliminating protection will certainly enhance trade in the products concerned.

[151] UNCTAD (2001), Ianchovichina et al. (2001).

[152] The QUAD comprises the EU, the US, Japan and Canada.

Improved market access is a prerequisite to increase trade and hence trade-generated growth. Trade liberalisation, including in sectors of interest to developing countries, and underpinned by stronger and more transparent multilateral rules, will be pursued in the context of the WTO trade negotiations, launched at the 4th WTO Ministerial Conference under the Doha Development Agenda (see Box 2).

Box 2: The Doha Development Agenda

1. Multilateral trade liberalisation provides the framework and the engine of world growth through a more efficient global division of production. At the November 2001 WTO ministerial meeting in Doha the world's trade ministers - the majority of which represent developing countries - agreed to launch a new round of multilateral negotiations on trade liberalisation and related rulemaking in the WTO - the Doha Development Agenda (DDA), which is more ambitious than any previous efforts.

2. At Doha WTO members committed to **focusing on the interests and concerns of developing countries**, thus ensuring that trade negotiations contribute to development. The new talks are expected to lead to the further opening of global markets and the facilitation of trade, especially in those areas where the developing world is most competitive.

3. The launch of the new round of trade negotiations now can boost growth at a critical juncture for the world economy. But the Doha Development Agenda also represents **a fundamentally different approach** to trade policy, launching broad negotiations under an overarching sustainable development objective, supported by trade related capacity building to help countries participate effectively. In this respect, the inclusion of environment on the international trade agenda is also groundbreaking; it should provide an instrument for improved global governance in this crucial area.

4. The DDA epitomises the **integrated approach to harnessing globalisation** promoted by the EU, and creates the basis for further changes in the global system. The inclusion of talks on a range of trade related issues such as competition, investment, trade facilitation and government procurement after the next WTO ministerial conference in 2003 should ensure that market liberalisation takes place in a broader regulatory framework, helping countries manage and maximise the benefits of reforms.

5. The agreement reached in Doha to negotiate a multilateral framework for transparent, stable and predictable conditions for **investment,** is an important factor in this context. Participation to such a framework agreement is expected to provide greater certainty and to reduce the perceived risk for potential investors, thus helping to increase the inflow of foreign direct investment – which is an increasingly important source of development financing; it helps to promote a healthy balance of trade, it encourages efficient production and stimulates technology transfer.

6. The negotiation of a framework on **competition**, as agreed in Doha, is expected to complement the investment agreement by helping countries to address anti-competitive practices by foreign or domestic firms and build efficient market structures, to the benefit of consumers and their economy more broadly. Directly related and important for the economic efficiency of countries, is also the agreement to negotiate, after the 5th WTO Ministerial, a multilateral agreement on transparency in **government procurement**.

7. Inefficient use of resources and infrastructure, time-consuming customs procedures and red tape continue to be a major constraint on developing country export performance. An agreement on trade facilitation in the WTO would aim to streamline procedures, cutting costs and red tape. The agreement reached in Doha to negotiate **trade facilitation** therefore constitutes an important contribution to development.

The effect of non-tariff measures on developing country exports is also important. In particular technical standards (TBT) and standards applied for health and safety reasons (SPS) can significantly impact the export opportunities of developing countries. While this is an issue that will require increased attention over the coming years, it is clear that the answer does not lie in a lowering of justified standards. Key instruments to help countries meet standards include support for their participation in international standard setting bodies and capacity building directed at relevant public and private sector actors. Similar challenges exist in the context of rules on intellectual property (the TRIPS Agreement), where support is vital to countries lacking domestic capacity to implement the agreement.

In the agricultural field, there is an evident need to reduce trade-distorting domestic support including all forms of export subsidies and to improve market access to address developing countries' interest in special and differential treatment, as well as the importance of non-trade concerns of agriculture such as food security, as was agreed in the WTO Ministerial in Doha.

The recent outcome of the Doha ministerial conference sets an agenda that all members fully benefit from the expansion of trade and that particular attention be paid to the needs and concerns of developing countries and the world's most fragile economies, in particular concerning food security, which is a key issue for most developing countries.

Food security is a multidimensional issue which needs to be addressed with coherent and long-term multi-sectoral strategies, both from an international and domestic point of view. Together with political dialogue and development co-operation trade is a key component of EU external action to contribute to poverty reduction.

Some developing countries have been disappointed by the lack of realisation of opportunities created by the Uruguay Round or by the extent of such opportunities. A number of developing countries perceived these as 'broken promises' (Oxfam (2001)) of developed partners. Their complaints sometimes refer to inadequate efforts made in areas like increased market access for developing country exports, such as dismantling of agricultural protection or improved access for textiles and clothing, but more often addresses the balance of the agreements as such and specifically a perceived bias in the Uruguay Round outcome towards developed country interests.

This disappointment with previous WTO agreements led to an ambitious work programme in the WTO relating to existing agreements, materialising in a ministerial decision at the 4th WTO Ministerial Conference in Doha in November 2001, which comprehensively addresses issues relating to implementation[153].

Beyond the multilateral level, regional liberalisation can be an important stimulus to further integration in the global economy. The number of Regional Trade Agreements (RTAs) has been multiplying in recent years. RTAs should reinforce co-operation on regulatory policies, including on the environmental and social dimensions of sustainable development, particularly in a North-South context. In addition they effectively lock-in necessary domestic policy reforms (in the political and economic area), enhancing their credibility and transparency. In both these respects, a very successful example are the Europe Agreements between the EU and the countries of central and eastern Europe (CEECs), which have underpinned CEECs economic transition over the last decade.

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[153] Doha also clarified the key issue of access to medicines in developing countries, with the recognition that TRIPS does not prevent members from taking measures to protect public health.

A key element in regional integration initiatives is the issue of regulatory approximation which increasingly emerges as a necessary prerequisite for attaining sustainable development objectives. Tariff dismantling at the border is one necessary step in the process of trade liberalisation. For goods and services to move freely among the parties, addressing trade-impeding regulatory barriers effectively is also essential. Therefore deeper integration or greater convergence/approximation of rules and regulations can help to fully achieve the potential gains from RTA participation.

In particular, progress towards the objective of liberalising trade in services and investment, should be accompanied by a common regulatory framework in areas such as competition policy, public procurement, rules of origin, intellectual and industrial property and norms and standards. This may increase the scope for benefiting from trade liberalisation inter alia contributing to the creation of an environment capable of attracting investment opportunities, but attention must be given to potential administrative costs of implementation for developing countries and the need to avoid the creation of overlapping sets of rules.

The costs of adjustment to trade liberalisation are a significant challenge to developing countries. The inclusion in RTAs of efforts to agree to common disciplines for regulatory regimes exacerbates such a problem. Flanking policies are therefore paramount to help offset the significant loss of government tariff revenue and increased opportunity cost of administering RTA rules.

It is often argued that for most developing countries and especially for the poorest ones, a North-South RTA with a large industrial country is likely to be superior to a South-South RTA among developing countries, provided the right design encourages the necessary domestic reforms.

However *North-South and South-South integration can be complementary*. The EU in most of its RTA initiatives promotes regional integration along South-South-North lines, where the advantages of trade liberalisation between a developed North and a developing South (locking in reforms, credibility, good governance, convergence, access to large markets, FDI incentives, technology transfers, etc.) are combined with the benefits of regional integration among the developing countries themselves (economies of scale, increased bargaining power, larger markets attracting more FDI, etc).

Trade-related Capacity Building

In addition to trade preferences, a comprehensive approach is required to enhance trade capacity if developing countries are to take advantage of the opportunities that trade liberalisation offers. Measures would include increased levels of comprehensive trade related technical assistance and capacity building to help countries participate effectively in the multilateral trading system. In the short term, such assistance should focus on the ability of countries to participate effectively in the WTO trade negotiations, both as regards substance, by identification of interests and objectives, and the more process-related aspect of developing their negotiation capacity and skills. In the WTO, the Doha Development Agenda Global Trust Fund has been created to ensure funding of the WTO technical assistance programme that is being implemented to assist developing countries in relation to new negotiations. Other international organisations, such as UNCTAD and the World Bank as well as specialised agencies such as the World Customs Organisation and the World Intellectual Property Organisation, are also important contributors of trade related technical assistance and capacity building to help countries participate in the multilateral trading system.

Co-ordination of this support is important to ensure complementarity and avoid overlap. Multilateral programmes, such as the Integrated Framework for Trade-related Technical Assistance to the Least Developed Countries and the Joint Integrated Technical Assistance Programme, which involves several donor agencies, are examples of co-ordinated multilateral programmes, targeting the poorest countries (Least Developed Countries and Sub-Saharan African countries respectively).

In the medium- to long-term, assistance should be directed at building countries' capacity to implement the negotiation outcome, including assistance for regulatory and administrative capacity, and to make use of the market access opportunities by building trade capacity. In this context, private sector development is also important.

Viable and effective trade related technical assistance and capacity building in the longer term requires mainstreaming of trade into development programming and into the overall development strategies of developing countries as defined in Country Strategy Papers or Poverty Reduction Strategy Papers. As regards the EU, trade and integration into the world economy have been identified as one of six priority objectives for development policy.

Accompanying Policies

Appropriate accompanying policy frameworks and good governance are essential elements of a strategy to ensure that all countries benefit from the opportunities for growth and development created by trade and investment liberalisation. The introduction of economic reform and flanking policy measures will often require support from the international community by co-operation to support economic reform and enhance the stability, transparency and credibility of the policy environment in developing countries, where domestic savings and investments are low (as e.g. the EC is already doing through partnership agreements, such as MEDA and the Cotonou agreement with the ACP countries).

Governance at a global level, by international co-operation and rule-making, can help support and lock in domestic reform, thus providing greater stability and predictability. As regards *trade policy*, a rules-based multilateral trading system is likely to be the best guarantee for a stable, international macro-economic framework and predictability in trade and investment conditions world-wide. In addition to the positive impact on export conditions, such an international framework could help to support and sustain the necessary domestic policy reforms. The DOHA WTO meeting agreed to negotiate international frameworks of rules on investment, competition, government procurement and trade facilitation is significant in this context.

A framework of rules on investment, under which countries would subscribe to fundamental principles such as non-discrimination, transparency and predictability, would help to underpin national investment regimes, while leaving the formulation of such regimes to the governments themselves. Participation in such an agreement would provide greater certainty and reduce the perceived risk for potential investors. It would also contribute to creating an environment more conducive to domestic and foreign investment, which can bring technology, employment and growth, build capacity and improve the trade performance of countries, and would be particularly important for low-income developing countries.

As regards competition rules, negotiations in the WTO will aim at agreeing on a basic framework agreement, including core principles of domestic competition regimes, modalities to benefit from international co-operation and support for capacity building in developing countries. This would not entail a harmonisation of domestic laws and there would be

flexibility as regards the introduction of domestic competition law or the maintenance of exclusions from the application of such law. A multilateral agreement on competition would complement an investment agreement by helping countries to address anti-competitive practices by foreign or domestic firms and build efficient market structures. The introduction of domestic competition policies would help countries to manage large investors and ensure economic efficiencies, thus increasing the benefit to the local consumers and economy. Further negotiations have also been agreed to clarify and improve anti-dumping rules with a view to limiting possible abuse by both developed and developing countries.

The negotiation of an agreement on trade facilitation in the WTO will aim at streamlining customs procedures, cutting costs and red tape, which continue to be a major constraint on developing country export performance. A trade facilitation agreement would imply significant savings, in particular for developing countries, by helping governments to improve efficiency of controls and, ultimately, ensure higher revenue intakes. The gains are expected to be particularly important for small and medium-sized enterprises in developing countries, for which the costs of compliance with trade procedures are proportionately higher and a disincentive to international trading. Simplified trade procedures are also frequently cited by business groups as constituting an important factor in FDI decisions.

Negotiations on trade and environment, which were launched at the 4th WTO Ministerial, are equally important for developing countries. Not only do they aim at addressing particular market access concerns of developing countries; the increased certainty that would follow from a clarification of the interface between trade rules and multilateral environment agreements would ensure predictability in market access conditions, thus limiting the risk of abuse of environmental considerations for protectionist purposes. It would also provide developing countries with opportunities regarding increased exports of environmental products.

A.4. Attracting Foreign Direct Investment

In recent years, FDI[154] has received increasing interest from policy-makers, due to its growing economic importance for both developed and developing countries. Sales by foreign affiliates are now more than twice than world total exports of goods, implying that firms use FDI more than they use exports to service foreign markets[155].

The on-going preparations of the Financing for Development Conference also stress the important role that FDI can have for economic development and hence poverty reduction[156], through technological transfer, productivity increases or enhancement of export capacity. At the same time, anti-globalisation protesters point at the negative side-effects that multi-national companies can have on the host economy: rent-extraction, crowding-out of domestic investment, repatriation of profits, as well as the irresponsible exploitation of natural resources.

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154 Foreign Direct Investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control (usually above 10%) of a resident entity in one economy in an enterprise resident in another economy (OECD (1993)). This definition captures both 'green-field' investment (i.e. when a new plant is built in the host country) and 'brown-field' investment (i.e. the partial or total acquisition of existing local firms).

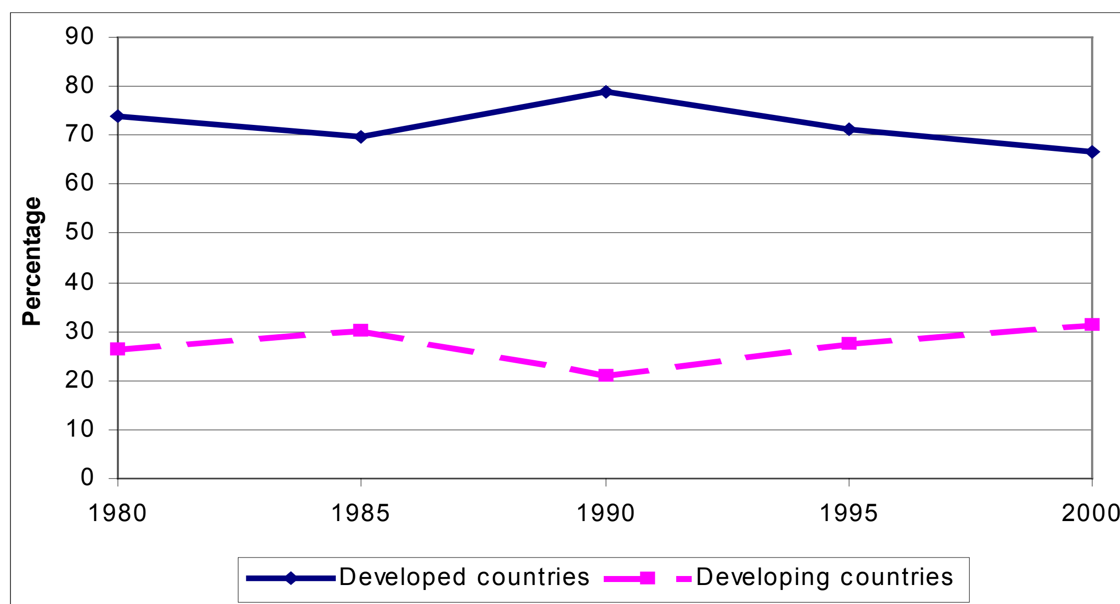
155 UNCTAD (2001).

156 See the Revised Draft Outcome, UN (2001a).

A.4.1. Trends and Figures

One of the most positive trends in developing countries has been the increasing importance that private capital flows have assumed over the past decade. Private capital flows totalled 87% of all net long-term capital flows to developing countries in 2000 (Table 2, section A.1.1); between 1990 and 2000, they averaged 75%. Among these, FDI is by far the largest and most stable source of capital, at around US$ 180 billion in 2000 (70% of total private flows).

Figure 14: Distribution of World Inward FDI Stock (%)



Source: *World Investment Report* (UNCTAD) various issues.

However, on a global scale developing countries only attract marginal amounts of FDI: in 2000, 21% of total FDI inflows were in developing countries.[157] On the other hand, the importance of developing countries as hosts has been slightly growing in the past two decades, with their share in inward FDI[158] stock going from 26% in 1980 to 31% in 2000 (Figure 14). FDI inflows in percentage of gross fixed capital formation, a good measure of the importance of FDI in the economy, have also steadily grown for the developing countries: from an average of 5% between 1989 and 1994 to 11% between 1995 and 1999.

In the geographical distribution of FDI, major differences exist among developing regions (UNCTAD (2001)). Africa has actually seen its share of inward FDI stock within developing countries being reduced from 10% in 1980 to 5% in 2000, while a less dramatic reduction has been observed for Latin America and the Caribbean countries (from 36% to 31% over the same period). Foreign investors in the past 20 years have favoured Asia, which has witnessed an increase from 53% in 1980 to 64% in 2000; the most spectacular increase has been seen in China, which saw its share growing from zero to nearly 20% over these two decades.

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[157] UNCTAD (2001).

[158] Inward FDI stocks are estimated as the cumulation of inward FDI flows (UNCTAD (2000)).

FDI is also very concentrated within each region, with the three top recipients accounting for more than half of FDI inflows. In 2000, Angola, Egypt and Nigeria represented 50% of total FDI inflows into Africa; Brazil, Argentina and Mexico 66% in Latin America and the Caribbean; while Hong Kong (China), China and South Korea accounted for 80% of FDI inflows to Asia. Even though this high concentration is often proportionate to the size of the country (which mostly reflects the amount of potential sales), it also illustrates the fact that many countries have not yet been able to attract the full potential flow of investment, notwithstanding their liberalisation efforts.

The main source countries of FDI into developing countries are also differentiated by region. For Africa, main sources have traditionally been France, the UK the US, and to a lesser extent Germany and Japan. Canada, Italy and the Netherlands have recently gained in importance. In Latin America and the Caribbean, after the US and Japan, Spain is the largest single investor in the region. In Asia, the US, Japan and European countries are all investing, while Asian countries themselves are investing in the region (e.g. South Korea).

A.4.2. Impact of FDI on Developing Countries

The economic literature tends to agree on the overall positive effect of FDI on economic growth in the host economy[159]. A distinction can be made between the impact of FDI at a microeconomic level and at a macroeconomic level. At the microeconomic level, the channel of this effect mostly goes via technological transfer, whereby contagion and knowledge diffusion improves productivity and efficiency in local firms in various ways, and hence growth. One of the channels is through backward and forward linkages between multi-national enterprises (MNEs) and local firms. The former refers to linkages between MNE and local suppliers, who benefit from better organisational structures and management skills learnt from contacts with foreign firms. Local suppliers may also have to meet higher standards of quality or delivery speed, if they want to deal with foreign firms. The overall result is that technological transfer gradually makes local labour more skilled, and hence local suppliers become more competent at producing the required intermediate goods for the MNEs. Similarly, forward linkages concern all spillovers towards distributors, again in terms of organisational or managerial skills transfer.

Active technological transfer arises when training of local employees by 'imported' managers, either in technical skills or in more intangible ones (such as marketing, customer service, etc.), leads local workers to end-up creating their own firm. Passive technological transfer arises when local firms see their profits threatened by more efficient MNEs and therefore have to increase productivity by introducing new technologies or even just by being more efficient in their production process.

The empirical evidence on positive FDI spillovers is mostly consistent for developed countries, while it is more mixed for developing countries (Blomstrom, Globerman and Kokko (2000)). Evidence on Latin American middle income countries shows positive spillovers for Mexico (Kokko (1994)) and Uruguay (Blomstrom et al. (1994)), while Aitken and Harrison (1991) find no evidence for Venezuela.

From a theoretical point of view, the beneficial effect of FDI should be particularly strong in developing countries, as foreign technology may be the only source of innovation, given the few resources available at both private and government level to invest in R&D. However,

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159 See Blomstrom and Kokko (1997) for a review.

developing countries may not have the minimum level of knowledge that is necessary to 'absorb' the foreign technology (Borensztein et al. (1998)). This technology gap between foreign and local firms may prove particularly large in the case of 'resource-based FDI' such as for oil or gas extraction, where the gap between the MNE and its environment is so wide that the dynamic benefits of technological transfer do not arise (Lim (2001)). The recurrence of the theme of 'absorptive capacity' therefore emphasises the role to be played in developing countries by human capital and investment in education.

The effects of MNEs on the market structure of the host country are not entirely clear. Through technological transfer, MNEs may force local firms to become more efficient and increase the general level of competition. However, they may also force out inefficient firms and become monopolists, given their better use of economies of scale and firm-specific assets, in which case FDI could lead to lower welfare in the host country. Moreover, MNEs may intentionally choose sectors where competition is low, or where entry barriers, such as high sunk costs, exist, to impose a monopolistic structure. Competition policies and their effective enforcement are important instruments to address this aspect. The nature of FDI is also relevant: a green-field investment, e.g. the establishment of a new plant, may indeed reduce the concentration of the market, while a simple acquisition leaves it unchanged or increases it. Unfortunately, the empirical evidence on this subject has been inconclusive and the impact of FDI on market structure remains an open question.[160]

In developing countries market structures tend to be imperfect, with a low degree of competition. If this is coupled with a restrictive inward investment regime (e.g. with mandatory joint partnerships or domestic content requirements) it may lead to attracting less efficient MNEs or those that use older technology (Moran (1998)), which therefore do not generate strong positive spillovers. Moran also points out that a liberal trade and investment climate is also conducive of export-oriented MNEs, which due to their exposure to international competition often bring new technology.

At a macroeconomic level, three main issues arise within the impact of FDI on developing countries: domestic investment, employment and trade. Most government policies are especially designed in order to attract FDI flows that would benefit these three aspects, as illustrated by Sun (1998) for the Chinese case. Domestic investment fuels growth; if FDI is conducive to greater investment, it will indirectly induce development. In this respect, joint-ventures allow local firms to gain the much needed financial and physical resources for new projects. This is often the only way for developing countries to get financial resources, especially when markets are too restrictive to be attractive for foreign portfolio investors.

Again the form of FDI matters for its impact on domestic investment.[161] Acquisitions are merely a change of ownership, while green-field FDI has an immediate impact on domestic investment. The other side of the coin may be a 'crowding-out' effect on domestic investment by FDI, especially when local resources (capital or labour) are scarce. As mentioned above, better organised and financially sounder MNEs may out-compete local firms and they may therefore capture the best investment opportunities in developing countries. The empirical evidence generally shows that MNEs have a positive impact on domestic investment.[162]

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160 Caves (1996).
161 Nunnenkamp (2001).
162 See again Sun (1998) and Borensztein et al. (1998).

As far as employment is concerned, the effects are on the number of employed people or on their wages. In developing countries, it is most likely that MNEs will employ labour-intensive processes, precisely in order to take advantage of low labour costs, hence increasing employment opportunities. In terms of wages, since MNEs 'export' their knowledge-capital to combine it with cheaper labour, often wages offered by foreigners are higher than elsewhere in the local economy. As a result, MNEs may increase the wage gap between 'skilled' (relative to the average local workers) and 'unskilled' workers in the developing country, hence posing problems of rising inequality.[163]

Trade and investment are complementary aspects of countries' integration in the global economy. Empirical studies usually show that FDI can enhance the export capacity of the host country and this is especially true when foreign investors use the host country as a platform for exporting, rather than for selling in the local market.[164] In this sense trade and investment can be seen as complementary and countries with open, predictable trade policies can more fully contribute to FDI's growth potential.[165]

The fear that some may have that FDI could lead to a deterioration in the trade balance of the developing country seems to be unjustified. Vertically integrated MNEs would usually use imported intermediate goods, which impacts negatively on the trade balance; however, this is offset by the fact that they will also export back their final product and that the value of final goods will exceed that of the intermediate goods. In terms of spillovers, export-oriented MNEs may also benefit local firms through backward linkages, i.e. by purchasing domestically produced intermediate products and by improving their 'market-access' capability at an international level, and eventually lead to an increase in direct exports from local firms, with a positive effect on the trade balance.

Overall, the impact of FDI on growth in developing countries depends on various elements directly linked to policy choices: a minimum level of human capital, a competitive economy with liberal investment climate and a liberalised trade regime.

A.4.3. The Challenge of Attracting FDI

Given the perceived benefits of FDI on the host economy, developing countries elaborate initiatives to attract foreign investors (such as tax holidays or other fiscal incentives) while at the same time designing schemes to encourage as many positive spillovers as possible (e.g. by imposing joint-ventures, local content requirements or the use of specific technologies).

When looking at the determinants of FDI, it is clear that many are exogenous to government policies, such as geographical position, country size and availability of natural resources. The most robust empirical finding concerns country size, with which FDI is positively correlated.[166] Beyond these, necessary conditions include economic, political and regulatory fundamentals (such as good governance, rule of law and intellectual property rights protection) that ensure a stable environment for foreign investors. These are first and foremost the responsibility of local governments. Several empirical studies show in fact that corruption,

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163 See Feenstra and Hanson (1997) for the case of Mexico.
164 Athukorala and Menon (1995) for the case of Malaysia, and Jansen (1995) for the case of Thailand.
165 Balasubramayam *et al.* (1999).
166 Brainard (1997), Shatz and Venables (2000).

complex and non-transparent regulatory frameworks, as well as weak property rights all hamper FDI.[167]

The liberalisation efforts in developing countries have accelerated since the 1990s with, for example, the elimination of licensing requirements, opening of previously closed sectors, unlimited foreign ownership, or making tax systems more neutral.[168] Moreover, trade and foreign exchange transactions were further liberalised and the functioning of financial markets was improved. A series of survey studies between 1987 and 1999 on 28 developing countries show that all these countries improved their investment climate, with beneficial effects on attracting FDI.[169] Efforts of developing countries in this direction can only be welcome, while it should be clear that most responsibility lies at home, rather than with the international community.

The desirability of active government investment-promotion policies, in addition to these necessary conditions, is not entirely clear. Evidence shows that such policies do have a strong positive impact on attracting foreign investors.[170] However, the cost of 'marketing' the potential host country abroad can be a real issue for some developing countries with scarce resources. Moreover, sector-specific promotion programmes in particular can create major distortions in the allocation of investment resources within a country.[171] The main role and challenge for international institutions should therefore be to create mechanisms that facilitate FDI more globally.

Some mechanisms are already in place, such as the Multilateral Investment Guarantee Agency (MIGA), created in 1988 (World Bank Group) to promote FDI into emerging market economies. MIGA offers political risk insurance (guarantees) to investors and lenders, and helps developing countries attract and retain private investment. Moreover, MIGA's guarantee coverage requires investors to adhere to high social and environmental standards.

Making sure that all developing countries with a proper investment climate fulfil their potential in attracting foreign investors is crucial. Advisory services, such as the Foreign Investment Advisory Service, created in 1985 within the World Bank, can help countries to reach their potential for attracting FDI, especially when disadvantages due to reputation effects are present (as in the case of Africa). Studies on herd behaviour within FDI have in fact shown that for investors entering a new market it may be an important signal to see that other investors are already established in the host country.[172] This may in turn induce more and more investors to explore business possibilities in that country. Similarly, some developing countries may be 'stuck' in a no-FDI position, only because there never was an investor in the first place.

From another perspective, investment agreements may also be helpful in ensuring that appropriate protection to foreign investors is guaranteed. At a bilateral level, the network of Bilateral Investment Treaties (BITs) has considerably expanded since the 1980s: in 1998, 39% of BITs were signed between developing countries, while 36% were signed between developing and developed countries.[173] Regional agreements involving investment

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167 Hoekman and Saggi (1999), Wei (2000), Drabek and Payne (2000).
168 World Bank (2001a).
169 European Round Table of Industrialists (2000).
170 Wells and Wint (1990).
171 Moran (1998).
172 Kinoshita and Mody (1997).
173 UNCTAD (1999).

frameworks have also proliferated throughout the developing world (within ASEAN, CAEMC, WAEMU and MERCOSUR).

As far as EU initiatives are concerned, most bilateral agreements create the conditions for encouraging inward direct investment with partner countries, through the establishment of regulations on investment and the repatriation of profits, as well as provisions for investment promotion and protection (examples include Stabilisation and Association Agreements in the Balkans, Agreements with ex-CIS countries and Euro-Med agreements). Within the Cotonou Agreement signed on 23 June 2000 with ACP (Africa, Caribbean and Pacific) countries, an Investment Facility has been put in place, which allows amongst other things to provide guarantees in support of foreign investment.

While bilateral investment treaties may be a useful tool in ensuring and sustaining stability in investment relations with important recipient countries, the sheer number and complexity of such treaties are problematic, not least for developing countries with limited regulatory and administrative capacity. A multilateral framework of rules would be more cost-effective, and in addition provide a higher level of transparency and stability, while ensuring non-discrimination. These benefits are particularly important for developing country governments.

The failure in 1998 of the MAI (Multilateral Agreement on Investment) launched within the OECD in 1995 (giving non-OECD members only observer status), indeed showed that the proper forum for such an agreement should be a comprehensive multilateral one. Developing countries in fact resisted the loss of discretion in policy instruments, even though a "tie one's hands" strategy may increase credibility in providing a sound investment climate. At the Doha Conference of November 2001, the 144 members of the WTO have agreed on the case for a multilateral framework on FDI, that will be negotiated after the 5th Ministerial meeting of 2003. Thus, during the next few years the main policy challenge concerning FDI, for developed and developing countries alike, will be the negotiation, within the WTO, of the right framework on investment. This should help to ensure transparency, predictability and non-discrimination for FDI, and hence support higher levels of FDI worldwide.

B. Alternative Financing Instruments

Over the years, a number of other financing instruments have been proposed to complement official development assistance. As several of them, including the Tobin tax, take the form of international taxes, they are treated as a group (section 1). Two other proposals, an SDR (Special Drawing Rights) allocation and the De-tax, are discussed in section 2.

B.1. International Taxes

The issue of an international tax to finance development is not new. International taxes have, for example, been suggested as part of a solution for development both in the North-South Report, by the group chaired by Willy Brandt in 1980, and in Our Common Future, the report of the World Commission on Environment and Development chaired by Gro Harlem Brundtland. The discussion on international taxes has mainly taken place within the discussion on financing of the United Nations and its activities.[174]

In addition to financing development, international taxes have been proposed as a way to finance the provision of global public goods. Proponents argue that global public goods are

[174] In addition to the reports mentioned, see for example Cleveland, Henderson, and Kaul (1995) and Najman and d'Orville (1995).

best dealt with and financed at the global level. As efforts to provide a more safe, healthy and stable world benefit all, some international taxes could in this context be seen as a charge paid by those that benefit from these efforts.[175]

Several tax bases have been proposed. A tax on currency transactions has so far received the greatest attention. Other proposals have discussed a tax on global activities or on the use of global public goods. Examples on proposed tax bases include, for example, air transport or airfreight, telecommunications and postal services, maritime shipping, trade, arms export, and carbon dioxide emissions. The issue of international taxes was raised again in the recent Zedillo report.[176]

This section focuses on four proposals, which are most often referred to within international fora. The purpose is to assess the feasibility and to discuss the implementation issues of these international tax proposals as well as their efficiency and potential revenue. The taxes under review are a tax on currency transactions, a tax on carbon dioxide emission, a tax on aviation fuel and a tax on arms exports.

B.1.1. Taxes versus National Contributions

The principle of a tax is that it is levied on certain activities to finance public goods without being earmarked. This enables resources to be used in the most optimal way when circumstances change. While an international tax offers the same financing flexibility as ODA resources financed out of national budgets, international taxes, once agreed, would become compulsory and would circumvent the current difficulty of voluntary contributions from governments.

However, developing international taxes would be a major challenge to international co-operation and co-ordination, both to reach a political agreement in principle and to work out the legal and administrative infrastructure ensuring a proper implementation of the tax. Moreover, an international tax could be seen as less fair from an equity point of view than contributions based on GNP.

The EU experience shows how difficult it is to establish supra-national taxes. The EU has developed a secure and efficient system to finance its policies. It enjoys a fair degree of financial autonomy, although the lack of a transparent link between the taxpayer and the beneficiary of the revenue is seen as an element of the democratic deficit of the EU institutions. The revenue side of the budget is closely linked to common policies, with genuine own resources (customs duties) and receipts from the application of a uniform rate to a harmonised VAT base. Reforms in the 1980s have, however, shifted the emphasis towards a contribution system, mainly because of equity considerations (UK correction in 1984, introduction of the GNP contribution and the capping of VAT resource in 1988). This move away from supranational taxes has taken place despite the existence of an advanced economic and political integration with the corresponding well-developed institutional and legal framework. As the current framework of non-EU international co-operation has not reached such a degree of integration, the feasibility of reaching agreement on introducing international taxes and making them operational can be questioned.

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[175] Najman and d'Orville (1995).

[176] UN (2001b).

While the distinction is not always easy to make, it may be important to distinguish between charges and taxes in this context. A tax is, according to the OECD working definition, a compulsory unrequited payment to the government. This definition excludes charges and penalties, but includes for example social security contributions since they are compulsory. A charge represents, on the other hand, a payment for a specific service. The individual user is able to derive a particular benefit or service from the charge, and the proceeds are earmarked to a specific use.[177] When discussions have taken place in international fora, for example on the aviation fuel tax, some have argued that it might be easier to organise the financing of specific international public goods through charges or other economic instruments instead of taxes.

B.1.2. The framework of International Tax Proposals

International tax proposals generally have a dual objective. They aim to raise revenue as a means of funding development or the provision of global public goods, but they are also seen as useful policy instruments to correct for economic distortions and externalities by inducing a change of behaviour through changing the relative prices between different activities. Some of the externalities are global by nature, thereby justifying a response at the global level.

1. Currency Transaction Tax (CTT)

The tax that has raised the most attention is the tax on foreign exchange transactions. As discussed in Chapter II, Nobel Prize winner James Tobin launched in 1972 the idea of a tax on foreign exchange transactions to discourage short-term speculative capital flows. Tobin's main concern was that the margin for manoeuvre of the monetary authorities in industrialised countries had been significantly reduced by the increased capital mobility. The Latin American and Asian crises in the 1990s have reopened the debate on the link between financial crises and capital mobility in unstable economic areas, with a special focus on 'peripheral currencies'. This gave rise to new proposals, in particular by Spahn (1996) and Schmidt (1999). Apart from its proclaimed potential to stabilise exchange rate markets, proponents of the tax have highlighted the potential proceeds of such a tax, and suggested turning it into an attractive source of additional revenue for the fight against poverty.

2. Carbon Tax

An international carbon tax has been discussed as a way to internalise the negative environmental effects of carbon dioxide emissions, through putting a price on emissions. The main advantage of a tax, compared to regulations, is that it induces emitters to choose an efficient, cost-minimising pattern of abatement. For this to be the case, the tax should be applied at a uniform rate across different users. As an international tax would equalise the marginal cost of emission reductions across the world, the emission reductions would be allocated so that the total costs for the world are minimised. However, the effects on different countries would be different in terms of national costs, depending on weather conditions, the energy supply mix and the industrial structure. Another advantage of environmental taxes is that they induce technological change, as savings in terms of reduced tax payments can be realised for all emitters.

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[177] The International Bureau of Fiscal Documentation, the International Tax Glossary on http://www.ibfd.com

Taxes on energy and carbon emissions have been extensively discussed. A tax on oil as a source for financing development was for example suggested in the Human Development Report of 1994[178], which proposed a US$1 per barrel tax on oil consumption and the equivalent on coal. However, the issue of an international carbon tax has mainly been discussed in relation to the negotiations on the United Nations Framework Convention on Climate Change (UNFCCC) as an instrument to reduce emissions. There was a discussion on the concept of a tax in the beginning of 1990's. However, the agreement reached in Kyoto in 1997 sets emission targets for the individual states and the EU, while leaving it to the countries to decide how this will be accomplished. At an international level, the Kyoto protocol focuses on other economic instruments: emission trading, joint implementation and the clean development mechanism.[179]

The issue of a global carbon tax was raised again in the Zedillo Report.[180] According to this proposal, industrialised countries should transfer a share of their carbon tax receipts that correspond to an agreed base rate to the international level, while developing countries would be allowed to recycle all their tax receipts into their own economies. The Report finds an international carbon tax more promising as a source of funding international development than a tax on currency transactions.

3. Tax on Aviation Fuel

A tax on fuel used for international aviation is an indirect tax on emissions from aviation. Like the carbon tax, the tax would internalise external costs by putting a price on the emissions of aviation. It would also result in a more equal treatment in terms of internalising external costs across different transport modes[181]. This argument also holds with respect to the tax treatment of domestic and international aviation, as some countries already tax domestic flights.

A tax on international aviation fuel has also been discussed as a source of funding of international development, but it has primarily been discussed as an instrument to mitigate the emissions of green house gases, in particular carbon dioxide. The aviation industry has grown considerably over the last 20 years, with an annual average growth in passenger-kilometres of 7,4% since 1980. The Intergovernmental Panel of Climate Change (IPCC) special report on aviation and the global atmosphere projects a growth of 5 % per year between 1990 and 2015, with fuel consumption and emissions growing 3 % per year over the same period. Aeroplanes accounted for about 2 % of total carbon dioxide emissions in 1992. This corresponds to 13 % of carbon dioxide emissions from transportation.[182]

The issue of a tax on international aviation has been raised in several international fora, for example in the UN Commission on Sustainable Development. A tax on aviation fuel has been discussed within the European Union on several occasions. The European Union favours an international initiative on a tax on aviation fuel in the context of the International Civil Aviation Organisation (ICAO)[183]. However, the current policy of ICAO, which remained unchanged by the 33rd ICAO Assembly in October 2001, is that it recommends the reciprocal exemption from all taxes on fuel taken on board by aircraft in connection with international

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178 United Nations Development Programme (1994).
179 The Kyoto Protocol is available on http://www.unfccc.org
180 UN (2001b).
181 European Commission (2001d).
182 IPCC (1999).
183 European Commission (2001d).

air services. As an environmental economic instrument, the ICAO favours an open emission trading system and at the meeting in October, the Assembly requested the development of guidelines for emission trading for international aviation.[184]

4. Tax on Arms Trade

A tax on arms trade or production surfaced in the debate on international taxation in the UN framework on global taxes in the 1990s[185]. Such a tax was considered as a legitimate contribution in the framework of initiatives of prevention of conflicts and peacekeeping. Various possibilities have been mentioned in the debate: a tax on production versus a tax on trade and a tax encompassing all conventional arms or just limited to land mines. However, no concrete proposal has been put forward. The French Minister of Finance has reactivated the proposal as an alternative to the currency transaction tax in the summer of 2001, with a main focus on the exports of arms[186].

B.1.3. Provisions and Features of the Tax Proposals

1. Geographical Scope and Coverage

The risk of relocation of taxable activities constrains the ability of national governments to tax them unilaterally. In the case of an immobile tax base, a unilateral tax would have an immediate impact in terms of competitiveness losses in relation to regions that do not apply the tax. The result would primarily be a loss of trade. If the tax base is mobile, this process is reinforced thought relocation of the taxed activity. Thus, unilateral taxes run the risk of affecting international flows and market shares, with corresponding effects on employment and wealth in affected regions. Furthermore, tax competition models demonstrate that co-ordination of tax policy between a group of countries or within a region is beneficial only if the mobility of the tax base is limited to the geographical border of the countries that co-operate[187]. Therefore, the introduction of a new tax by a group of countries of a region is likely to be more acceptable for less mobile tax bases. The tax would, in this case, have limited effects on relocation and competitiveness. The risk of relocation of economic activities is very high in the case of the tax on currency transactions, due to the high mobility of the tax base. The new technologies of electronic settlement systems make it easier to relocate financial centres to non-taxing jurisdictions. This is shown by the creation of the Eurodollar market in London after the introduction of the "Interest Equalisation Tax", a US Tobin-like tax. Given the nature of the two-sided tax, only if both sides of a transaction are conducted in a tax haven, would the tax be avoided in full. One partner will not have an incentive to shift his business to the haven unless the other does so at the same time. This lock-in effect can prove to be discouraging, but if not, the volume of the relocated activity will be extremely difficult to recuperate.[188] A unilateral application of the currency tax base could constitute a disincentive to the use of the taxed currency for the citizens, institutions and companies operating outside the currency zone. A unilateral geographical tax at, for example, the EU-level with respect to non-EU currencies clearly has a risk of relocation and substitution through other currencies.[189]

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184 ICAO (2001) .

185 See for example the proposal for the demilitarisation fund in the Human Development report 1994, UNDP (1994).

186 Malingre (2001).

187 Sørensen (2001).

188 Conseil Supérieur des Finances de Belgique (2001).

189 Assemblée Nationale de France (2000).

From this perspective, implementing a sustainable CTT would require a multilateral approach, including the willingness to apply the tax in the major financial centres.

While Tobin initially launched his proposal with the US in mind, shortly after the breakdown of Bretton Woods[190], the Spahn variant is specifically aimed at the peripheral currencies vis-à-vis the dollar, which accounts for about 20 % of total currency transactions[191]. In Spahn's view, there will be three key currency zones in the future: the dollar, euro and yen zone. Other currencies will be linked unilaterally to one of the key currencies, by stabilising the exchange rate or by applying the Spahn tax.[192] In contrast, Schmidt's proposal covers all currencies.[193]

There may be greater scope for co-operation on a regional level for the three other taxes under review (the carbon tax, the international aviation fuel tax and the tax on arms exports) as they have less mobile tax bases. However, partial relocation or tax planning activities might take place.

An extensive geographical coverage may also be essential to secure the effectiveness of a tax on aviation fuel. A tax on international aviation fuel with a limited geographic scope could result in an increase of emissions. An airline's desire to reduce fuel costs could cause planes to be re-routed, particularly on long-haul flights. Taxes could also be avoided by tankering, which is when an aircraft takes on more fuel than is needed for a flight to avoid purchasing more expensive fuel at the next stop. However, this also requires using additional fuel to carry the extra fuel load. In a study for the European Commission on an EU-tax on all departing flights within EU, it was estimated that tankering could reduce the tax revenue by 25% and the emission reduction by up to 70%.[194]

Implementing a tax on arms exports is facilitated by the high concentration of this industry in a limited number of countries, mainly the US, France, the UK and Russia, although concentration is difficult to measure exactly as arms export volumes are not regularly published nor stable over time. The French proposal estimates that the US, France and the UK accounted for 70% of the world arms exports between 1993 and 2000. Major exporting countries have made strong political commitments to support the control of arms exports and to reach a greater transparency in the arms trade. Major initiatives in this direction are, in particular the UN resolution to establish the UN register for conventional arms in 1991, the Wassenaar Arrangement approved in 1996 and the European Code of Conduct on Control of Arms Exports adopted in June 1998.

The major exporters could play a leading role in a tax initiative, although it has never been mentioned in any of these frameworks. The risk of relocating arms production might not be a major threat due to the high technology content of some segments of the arms industry and the importance of state contracts in the turnover of arm industries. However, during the 1990s, the military industry has been increasingly privatised and arms production has been internationalised through cross-border joint-ventures or mergers of arms producing companies[195]. Therefore a tax applied unilaterally by the major exporters might reduce the

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190 Tobin (1978).
191 See section II.C.1.3.
192 Belgian Senate (1999-2000)
193 The Schmidt proposal is described in Cassimon (2001).
194 The result is dependent on the evaluated tax level. In this case ECU 245/1000 litre. See Resource Analysis et al. (1999).
195 Sköns.(2000).

competitiveness of the domestic industry and could therefore require a wider coverage other than the major exporters.

2. Tax Base

The base for the tax needs to be clearly and unambiguously defined in order to facilitate equal collection and enforcement across nations. In order to capture the economic benefits of the taxes as presented above, the tax base generally needs to be as broad as possible. Defining a common tax base is seen as technically difficult for the tax on currency transactions and not straightforward for the exports of arms, while technical solutions might exist for carbon or aviation fuel taxes.

In the case of a *tax on currency transactions*, it is difficult to define the tax base. Introducing exemptions for obvious non-speculative transactions (such as traveller's currency exchanges and other clearly-defined non-speculative banking operations) and thresholds (to reduce the cost of smaller cross-border transactions) could open the door to tax avoidance. In the case of thresholds, it is of particular importance to take into account the costs of splitting transactions, both at the retail and at the wholesale market. It has been debated whether all spot market transactions, financial derivatives or financial markets as a whole, excluding the issuing of bonds and shares, should come under the scope of the tax.

Whether the tax should apply within a given country or to specific transactions regardless of where they take place remains an open debate. The field of application of a CTT can be defined geographically, can be based on the currency involved, or on a combination of both. A geographical definition implies that all foreign exchange operations executed on a territory are subject to the tax, independent of the currency. In contrast, if the base is the currency involved, it is the conversion itself that is taxed independent of where the transaction took place. In this view, all conversions in the taxed currency would be taxed even outside the relevant currency zone. Combining both options raises the question of whether both conditions should be applied or whether only one would suffice for taxation. If both conditions need to be fulfilled, only the conversions in the taxed currency executed within its currency zone would be taxed. In the second interpretation, all conversions within the currency zone are involved, independent of the currency, and all transactions in the taxed currency, independent of where the transaction takes place.[196]

Instead of taxing individual buying and selling operations, Schmidt proposes to tax net positions at the level of a centralised settlement system. This would circumvent enforcement problems related to the identification of intermediary transactions and financial derivatives. However, the Schmidt proposal still hinges on the coverage of electronic settlement systems, which are less used by developing countries. The settlement systems are developed on a voluntary basis to reduce settlement risk. There are neither reporting obligations nor standardised formats for supplying detailed information. Using these systems for a CTT would affect their structure and their legal status. Moreover, foreign exchange transactions do not necessarily involve banking operations and positions can be netted out between companies.[197] The CTT enforcement mechanism should also capture the non-banking part of the tax base in order to prevent the substitution of bank trading through non-taxable foreign

[196] Conseil Supérieur des Finances Belgique (2001).
[197] Verfaille (1999).

exchange activities. Even for inter-bank operations, the settlement systems include transactions that should not be part of a CTT base.

To be effective, a *carbon tax* needs to cover all fossil fuels according to their carbon content as well as all uses and users. One possibility is to levy the tax close to the source of the extraction of the fuel ("upstream tax") in order for the price signal to create a broad set of market responses as possible. This could be implemented at the mouth of a mine for coal, at the refinery gate for oil or at the pipe for gas. In contrast, the current European Community legislation on excise duties follows the destination principle; that is the tax is paid where the product is consumed. In practice, the tax is charged when the product is released for consumption, which will differ according to the product. To facilitate the trade in excisable products within EU, a system of suspension arrangements has been created under which taxable products can be moved without levying the tax within the EU. Depending on the stage at which the products are taxed, similar arrangements would have to be developed at the global level.

A *tax on international aviation fuel* could either be based on emissions, such as carbon dioxide, energy content or fuel price. A flat rate per tonne would give a different result than a percentage of the price, as fuel prices differ widely among regions[198]. As there are a limited number of actors and well-defined procedures for international flights, it should be relatively easy to define the taxable event.

A tax on arms exports could be technically defined as a customs duty, although customs duties are more commonly used on imports and the monitoring would be done through customs. One of the bottlenecks in the international fight against the *proliferation of arms* is the precise common definition of arms. Within the EU, the trade of conventional arms is regulated by Article 223 of the Treaty, and thus not a Community competence. The definition of the tax base could rely on the international agreements for arms control. The UN register for conventional arms, the Wassenaar arrangement and the European Code of Conduct on Control of Arms Exports have all defined lists of arms equipment. They have also adopted reporting obligations and systems of exchange of information between participating countries in their efforts to improve transparency. Several technical difficulties would need to be clarified, in particular whether the tax base would be limited to conventional arms or would include non-conventional arms, whether it would be limited to military weapons or would include small arms. Only the Wassenaar Agreement covers goods with dual uses, mainly high tech equipment or biological goods, which have both civilian and military applications. But the main difficulty for using these frameworks for tax purposes is that none of the agreements are m legally binding. In practice the reporting of exports of arms remains voluntary and is incomplete, ambiguous and not uniform across countries[199].

3. Tax Rate

In the case of a tax on currency transactions, there is no agreement on the exact tax rate to be applied. For the tax to be effective, the rate should be sufficiently high to provoke the desired effect. Current proposals vary from 0.003% to 0.25%. Spahn has introduced the notion of a prohibitive rate for the purpose of banning speculation on the foreign exchange markets. However, there is no agreement as to what rate is prohibitive. The answers have ranged from 10%-50% to 30%-100%.

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198 Michaelis (1997).
199 Carlman (1998).

According to economic theory, environmental taxes should be set at a rate such that the marginal damage cost is equal to the marginal cost of emission reduction. The implementation of the tax would then lead to a situation where the marginal abatement cost is equalised across emitters. However, the damage cost is very difficult to estimate in practice.[200] The damage cost estimates presented here are based on stabilising the concentration of green house gases in the atmosphere on a level equivalent to a doubling of pre-industrial levels. The IPCC Second Assessment Report (1996) presents an interval of estimated values, which range from $5 to $125 (US 1990) per tonne of carbon emitted. A study for the European Commission presents a narrower interval of $ 9,1 to $ 65,1, with a median value of $ 28 per tonne of carbon emitted (U.S. 1997).[201] These estimates represent a wide range and a great uncertainty in terms of determining an optimal tax level for carbon dioxide emissions.

4. Revenue

The revenue of a tax will depend on the level of taxation and the related behavioural change, as well as on several other factors, such as the geographical application of the tax.

Part of the interest for a tax on currency transactions in the current debate is its potential revenue collection. The French Treasury, the Finnish Ministry of Finance and the Belgian High Council for Finances present estimates of the tax proceeds and sensitivity of the results to various parameters. They start from the 1998 daily volume of currency transactions close to US$ 1500 billion as estimated by the BIS. Assuming a price elasticity of between –1.5 and 0.5, allowing for fraud or tax avoidance of up to 25%, the proceeds of a tax with a rate of 0.01% to 0.1% would be within the range of US$ 20 and 200 billion. Earlier estimates had been even higher, mentioning several hundred billion US-dollars. The more recent Spahn and Schmidt proposals, which apply the tax to a limited part of the base, would provide significantly lower revenues than these estimates. However, all these calculations are hypothetical and the absence of experience with such a tax makes it difficult to provide reliable estimates.

The same caveat holds for other international taxes. The models that simulate the effects of a carbon tax usually use the tax as an instrument to equalise marginal costs across users and nations. The focus is to evaluate the effects on the total economy, not on the generated tax revenue. The revenue is also channelled back into the economy in the different ways, which affect the result. Thus, it is difficult to give estimates on the potential revenue. However, estimates quoted in the debate range from US$ 66 billion for the UNDP(1994) proposal of US$1 per barrel of oil to US$ 750 billion per year according to Cooper (1998), using OECD model results for 2020. Cooper refers to global carbon emissions of 5,2 billion tonnes, implying an implicit tax rate of US$ 144 per tonne of carbon. Recent estimates of the marginal cost of carbon to implement the Kyoto Protocol targets would result in tax revenues in the lower range of this interval, if such targets would be implemented with a carbon tax. All these estimates point to large uncertainty, like in the case of the tax on currency transactions. As aviation fuel only constitutes a small part of the total use of fossil fuels, the revenue potential of a tax on aviation fuel is considerably lower.

No revenue figures have been mentioned in the discussion on the tax on exports of arms. As mentioned above, there is no precise estimate of the volume of arms trade. The volume is estimated to be in the range of €30 to 50 billion per year depending on the year and the

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[200] See for example Cuervo and Gandhi (1998) and OECD (1997b).
[201] Capros et al.(2000).

source. The Third annual report of the EU Code of Conduct on Arms exports indicates that export licenses issued by Member Sates amounted to roughly €15 billion in 2000. Carlman (1998) quotes a figure of US$ 10.8 billion for the 1997 US exports. UN data are more out of date but are still broadly in line with these figures. Whatever rate is applied, this tax base would not, in any case, generate proceeds of the order of magnitude mentioned for the tax on carbon dioxide or currency transactions.

5. Efficiency and Equity

Efficiency relates to the extent to which the tax will contribute to its objective and at which cost. As a general principle, it depends on the price elasticity of the tax base and the possibilities of relocation or substitution, which might reduce the tax base if a tax is introduced. Very little is known or can be measured in the cases of taxes which have not been applied in practice, such as a tax on currency transactions or exports of arms. The assessment of environmental taxes can draw on national or regional experiences, raising, however, the issue of computing a world-wide impact.

Equity is the second dimension to consider when assessing the impact of a tax. Horizontal equity refers to the principle that "equals should receive an equal treatment", while vertical equity refers to the progressivity of the tax among taxpayers. In the framework of an international debate, equity would, however, focus on the impact of the tax on the distribution of income between countries.

Very few studies have investigated the issue of equity for the currency transactions tax. In this context, most of the focus has been on how to avoid that the tax penalises hedging activities on the retail market, as including hedging activities would result in a shift of the tax burden to households' and corporate sector's normal trade and investment activities. The overall impact of the tax on currency transactions on world income distribution depends primarily on the currencies covered by the tax.

As fossil fuels generally have negative price elasticity, even if it is low, a carbon tax would reduce emissions. Simulations of the impact on the economy generally indicates a negative effect on GDP growth at the national level, but the results depend heavily on how tax receipts are redistributed. Analysis of the distributional effects of carbon and energy taxes show that the effects on the income distribution of these taxes are generally regressive to neutral in relation to income in developed countries. Few studies have been done for developing countries, but the results of one study from Pakistan indicate that a carbon tax could be income neutral to progressive. The consequences in terms of total costs of an international tax would be very different for different economies[202]. This reflects large differences among countries in both the structure of energy use and in the available technology. Generally developing countries are more carbon intensive in relation to GDP than developed countries[203]. This translates into greater percentage losses in relation to GDP for developing countries of an international carbon tax. However, the net effect on different countries will depend heavily on how the revenue is allocated. In addition, there is the efficiency gain of the optimal allocation of emission reductions across the world, in comparison to a situation with uncoordinated taxes on the national level.[204]

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202 Cuervo and Gandhi (1998).

203 Figures of energy intensivity in relation to GDP are available on http://www.eia.doe.gov/index.html

204 Cuervo and Gandhi (1998) and OECD (1997).

An international tax on aviation fuel could contribute to reduced emissions from aviation. An increase in the cost of fuel would be passed on to airline customers and would result in a lower demand for air travel and freight. It would be expected that airlines would also respond by reducing their fuel consumption through changes in their operations, as well as through the use of more energy efficient aircraft. Both these responses would result in lower emissions. Airline profits would though be negatively affected, particularly in the short-term. An international tax on aviation fuel would also affect parts of the world differently. Nations or regions that are dependent on long distance transport for trade and tourism would be disproportionately affected when compared to other countries. However, the overall effects are dependent on the level of the tax rate.[205] It should also be noted that other economic instruments, for example emission trading or revenue neutral charges, could be equally efficient environmentally.

A tax on arms exports would undoubtedly be seen as a way of strengthening the commitment of arms exporting countries towards arms control initiatives. Whether arms purchases are price elastic and whether a tax would effectively reduce arms trade is open to debate. The overall effect of the tax on arms exports would need to be gauged against other forms of government support in the form of export guarantee credits, loans or grants to arms producing companies. Carlman (1998) mentions that 'more than half of the US weapon sales are now financed by taxpayers instead of foreign arms purchasers' and indicates 'similar tendencies in other major arms supplier countries.' It might therefore be more effective to withdraw subsidies than to introduce a new tax to curb proliferation of arms at the world level.

B.1.4. Legal Basis and Compatibility with Existing Legislation

An international co-operation on taxes could be undertaken in different institutional frameworks. One possibility is to establish a form of an internationally agreed code of conduct, which is not legally binding. The implementation of the tax would then take place in countries by national authorities. However, a code of conduct would still give room for tax competition through differences in the implementation and the interpretation of the code. In order to avoid the problems raised here, extensive international co-ordination would need to be based on a legally binding international agreement. The agreement would need to address all issues of the definition of the tax base, the level of the tax rate, the implementation and administration of the tax, in order to minimise the risk of tax avoidance. It would need an extensive coverage of countries in order to facilitate the implementation of the tax. Otherwise, there would be a risk of relocation of financial centres, polluting industries or flight hubs.

An international tax could be collected by the individual countries or by an international organisation. Both approaches raise questions on administration, compliance, audit, collection and costs. The key issue is how to ensure universal application, compliance and enforcement. In the case of collection at the national level, it would require an unprecedented degree of co-ordination among countries, such as a world wide exchange of information. Differences in legislation, in administrative standards and in application could give rise to relocation to places where the standards are known to be lax. An international body, such as an International Tax Organisation (box 3) would potentially solve some of these difficulties, but it would imply that the national governments would have to recognise the competence of the international body in defining the tax provisions, and collecting and controlling the revenue.

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[205] Michaelis (1997).

Box 3: Towards an International Tax Organisation?

The final report[206] of the High Level Panel on Financing for Development, chaired by Ernesto Zedillo, calls on governments to "consider the benefits of" an International Tax Organisation (ITO). To some extent, the call for an ITO flows from other parts of this report, in particular the suggestion that the world should introduce global taxation for the solution of global problems. In other words, a system of global governance dealing with issues such as development assistance, humanitarian aid and other global public goods requires global as well as sovereign taxes to finance them properly.

The panel's case for an ITO rests on three main pillars: (i) the tax systems of most countries developed at a time when trade and capital movements were heavily restricted. In today's increasingly global economy, the avoidance of double taxation therefore rests on conventions agreed by individual governments, but the report criticises these as "complex" and "in some respects arbitrary". (ii) The taxes that countries can impose on transportable goods and on mobile factors is "constrained" by the tax rates of others. Tax competition is leading to "tax degradation", and increased tax evasion with respect to income from capital located outside the taxpayer's country of residence. (iii) Given the panel's call for global taxation to finance global public goods, there would be a role for an ITO in developing and implementing such taxes.

It is clear that the panel sees the main benefit of an ITO as a way of combating tax evasion and restraining harmful tax competition. These would, it claims, contribute to increased tax revenues from dishonest taxpayers and mobile factors of production. The report claims that most people would regard this as an "unambiguous gain".

Activities[207] under the umbrella of the ITO could include: (i) identification of main tax trends and problems, and compilation and/or generation of relevant statistics and tax information, leading to the publication of an annual Tax Developments Report; (ii) provision of technical assistance to countries; (iii) development of international norms in tax policy and administration; (iv) acting as an arbiter and provider of surveillance over individual country, regional and global developments. The panel report adds a number of other possible functions of an ITO: (v) developing a system of unitary taxation of multinationals; (vi) promoting and enforcing a personal tax system whereby nationals are taxed on their world-wide income regardless of where they reside.

The panel acknowledges that other organisations are already addressing these issues or the effects of them – the OECD, UNCTAD and the IMF are mentioned. However, it argues that OECD membership is restricted - implying, although it does not say so specifically, that not enough countries have a voice in this organisation. The suggestion appears to be that an ITO would pull together the disparate work already being done, although again this is not explicit. In short, the tasks concerned would be better tackled at a global level.

Existing international institutions could also manage an international tax. However, this would require a substantial extension of their mandate and competence. Tobin has suggested that the revenue from a tax on currency transactions could be allocated to the Bretton Woods institutions, which also could be given a role in the administration of a tax. The Conference of the Parties under the United Nations Framework Convention on Climate Change is currently the forum for the international work and negotiations on climate change, and could play a role

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206 United Nations (2001b).

207 The report largely bases its proposals on a paper by V. Tanzi. Tanzi, V., "Is there a need for a world tax organisation ?" in Razin, A. and E. Sadka Eds. (1999).

in implementing an international carbon tax. For an international tax on aviation fuel the ICAO could play a role in the implementation and administration of a tax: 187 countries of the world's 194 (February 2001) are members of ICAO.

An international tax raises issues of compatibility with other international agreements as well as with national policies. A tax on transactions between the euro and currencies of other EU Member States is likely to be found contrary to the Treaties. Furthermore, the compatibility of a CTT applied by EU Member States vis-à-vis the rest of the world with the Community's obligations within the WTO remains to be explored.

A carbon tax could also raise problems of compatibility at the international level. The international community has already agreed on other instruments to reduce carbon dioxide emissions in the Kyoto protocol. At the national level, an international carbon tax could imply a loss of domestic revenue for those countries, including some Member States, that have already implemented a tax. For the Member States of the EU, there is also a question of compatibility with the Mineral Oil Directive (92/81EEC) as this directive exempts certain uses of fuel from excise duties on mineral oils.

A tax on aviation fuel, including a carbon tax, would raise problems of compatibility with the Convention on International Civil Aviation (the Chicago Convention) from 1944. The Convention provides that fuels on board on aircraft in transit should be exempt from customs duty, inspection fees or similar national duties or charges. In addition, numerous legally binding bilateral Air Service Agreements, which exist between individual states usually contain clauses to the effect that both fuel in transit and fuel supplied in the territory of the contracting party should be exempt from fuel taxes. This is consistent with the ICAO policy, "*which recommends inter alia the reciprocal exemption from all taxes levied on fuels taken on board by aircraft in connection with international air services*".[208] Furthermore, ICAO also recommends that environmental levies on air transport should be in the form of charges rather than taxes. Thus, the funds collected should be used within the aviation industry to mitigate the environmental impact of emissions from aviation. The 33rd session of the ICAO Assembly in September-October 2001 did not bring any change in this policy.[209]

A tax on exports of arms is likely to generate fewer problems of compatibility with international trade treaties. At the EU level, arms exports are not part of the Community trade regime although goods with dual uses are.

B.2. Other Proposals

B.2.1. The De-Tax

The De-Tax is a more recent proposal to provide additional financing for development purposes. Building on an Italian idea that goes back to the early nineties, it has been launched as an alternative to proposals for compulsory financing through taxation. Under this scheme, consumers would be invited to allocate a 1% rebate, granted by the vendor, on the value of their purchases to an international development project which the vendor has chosen to support. The government would exempt this contribution (it would 'de-tax' it) from VAT and company income tax. Apart from this tax subsidy, the role of the government would be limited to monitoring the ethical funds and their activities.

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208 ICAO (1996).

209 See also ICAO(2001) and ICAO (1994).

The De-tax scheme does not require an international agreement neither for the collection nor for managing and spending resources. It is completely voluntary as within each country, citizens and businesses are free to decide to participate.

The scheme looks attractive because, as is the case with the Tobin tax, potential revenue looks high. Even if only a minor part of shops and enterprises agree to participate in the scheme, and assuming that a significant number of customers endorse the project chosen by the vendor, the revenue could be substantial.

The voluntariness of the De-tax is, however, also its main weakness. The system rests fundamentally on the assumption that enterprises are prepared to forgo, on a permanent basis, 1 percent of their turnover. In terms of profit margins, this share will be much more substantial. While the system does provide an incentive through the tax rebate (which amounts to an involuntary contribution by all taxpayers), it is unclear why retail sellers and businesses would be motivated to participate in this particular scheme.

B.2.2. An SDR Allocation

Since the creation of the Special Drawing Right (SDR) by the IMF, proposals have been made for using SDR allocations for purposes other than the original one, which is coping with a long-term global need for international liquidity. The possible use of SDR allocations for the provision of development finance was already mentioned in the discussions leading to the creation of the SDR[210], and proposals of that kind have resurfaced regularly, most recently in the Zedillo report[211] and by George Soros[212]. While the Zedillo report does not elaborate on the post-allocation redistribution scheme, Soros explicitly proposes to redistribute the allocated SDRs through trust funds to specific countries and/or to finance the provision of global public goods.

The SDR was conceived in the 1960s as a response to the perceived inability of the international monetary and financial system to ensure adequate growth of international liquidity. Under the Bretton Woods gold exchange standard, international reserve creation was basically constrained by gold production and by claims on the reserve-currency country, a role assumed since World War II by the USA[213]. The growing concerns about the limits of international reserves creation was stated in two studies by the IMF and the G-10 which led to the proposal for the creation of new reserve assets[214], and to the creation of the SDR in 1969 through the first amendment of the IMF Articles of agreement.

The SDR is an artificial currency unit defined as a basket of the major currencies. The objective of the SDR was to supplement IMF members' existing reserve assets (official holdings of gold, foreign exchange, and reserve positions in the IMF). They are created through a process of allocation. A decision to allocate SDRs is made by the Board of Governors on the basis of a proposal by the Managing Director with the concurrence of the Executive Board, and requires an 85 percent majority of the total voting power. Two allocations of SDRs have taken place, the fist one in 1970 and the second one in 1981. On both occasions, SDRs were allocated in proportion to the quotas of Fund Members agreeing to this allocation.

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210 IMF (1987).
211 United Nations (2001b).
212 Soros (2001).
213 This problem was first formulated by Triffin (1961).
214 Ossola (1965).

The SDR should be seen as a means to obtain other reserve currencies from other Fund members. The system functions because Fund members holding less SDRs than their cumulative allocations pay an interest rate on this negative balance while the ones holding more SDRs than those received in allocations receive an interest to compensate for the yield lost on the exchanged reserve currencies. The SDR interest rate is the average interest rate of short-term instruments in the main reserve asset currencies.

The conditions that could lead to an SDR allocation are contained in the Fund's Articles of Agreement. Article XVIII refers to the existence of a long-term global liquidity need but refrains from specifying how this need is to be assessed: *"In all its decisions with respect to allocation and cancellation of SDRs, the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such a manner as will promote the attainment of its purposes and will avoid stagnation and deflation as well as excess demand and inflation in the world."* Experience has shown that it is not straightforward for an 85 % majority of the IMF Board to agree on the existence of long-term global need. This, together with the changes that took place in the international monetary system since the establishment of the SDR mechanism (suspension of gold convertibility, elimination of par values, evolution of international capital markets, and increased number of reserve currencies) explain why only two general allocations took place.

Decisions on an SDR allocation have, however, not solely been taken in light of a perceived global liquidity need. In 1997, the IMF Board of Governors acknowledged that the benefits of the SDR mechanism had not accrued equally to all IMF members: the early Fund members had been allocated SDRs twice, the ones who joined the IMF in the 1970s once and the rest (one fifth of the Fund membership which joined the IMF after the last SDR allocation took place in 1981) never. The Board therefore decided on a fourth Amendment to the Articles to allow for a one-time specific SDR allocation that would increase the ratio of allocated SDRs to quota for all IMF members to a same threshold. This allocation, which would result in a doubling of the amount of existing SDRs, has yet to enter into force. It will become operational when IMF members having 85 % of the total voting power will have accepted it, which will be the case with the acceptance by the US.

Proposals for SDR allocations such as the ones proposed by Soros and the Zedillo report attempt to bridge the "discrimination" between, on the one hand, countries that issue reserve asset currencies, and thus have access to almost spontaneous financing, and, on the other hand, developing countries that have hardly access to capital markets. The argument is that an SDR allocation provides all IMF members with additional "owned" reserves. These additional reserves could result in increased financial markets confidence. These reserves could also be used by developing countries, which are constrained in their ability to tap private capital markets at a reasonable cost, to buy the needed investment goods. The effect of a general allocation would be boosted if it were combined with a redistribution scheme that would put the SDRs that are allocated the creditor countries in a common pool.

The objectives of these proposals need, however, to be reconciled with the principles and procedures that govern the allocation and the use of SDRs.

It can be questioned whether it is appropriate to use monetary creation (which is what an SDR allocation is all about) to finance development. Opponents to proposals for using allocated SDRs to finance development have since the creation of the SDR argued that, as a principle,

considerations for the management of international liquidity and for the transfer of real resources cannot be reconciled in a single decision[215].

The creditor countries, as main IMF shareholders, also underline the importance of IMF conditionality. Conditional financing through the normal IMF facilities is more useful than the unconditional net use of SDR holdings because conditionality ensures that adjustment accompanies financing in debtor countries. They also fear that an SDR allocation would permit a spending spree by developing countries on unnecessary goods.

The SDR mechanism is also not cost-free. As already indicated, members holding less SDRs than their cumulative allocations pay an interest rate on that negative balance. While the interest rate charged for the use of those SDRs would probably be lower than the market rates for developing countries, this charge would also be substantially higher than the rate charged by the IMF under its concessional window.

Finally, an SDR allocation and/or amendment to the IMF Articles of agreement requires the acceptance of IMF members having 85 % of the total voting power, which makes it a rather lengthy, cumbersome and uncertain process, as shown by the equity issue allocation.

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[215] See for example Rey and Robert (1997).

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