

Multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office/UN DESA, at Nairobi Safari Club Hotel in Nairobi, Kenya from 30-31 March 2005

The third of a series of multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office took place at the Nairobi Safari Club Hotel in Nairobi, Kenya from 30-31 March 2005. Local co-organizers were the Friedrich Ebert Stiftung – Kenya and the Southern and Eastern African Trade Information and Negotiations Institute (SEATINI). The meeting was co-sponsored by the UN Foundation, Friedrich Ebert Foundation and the Swedish Ministry of Foreign Affairs.

The multi-stakeholder consultation was concerned with concrete proposals for reforming the International Financial Architecture (IFA) with a regional focus on Africa and low-income countries. The list of participants as well as the agenda of the meeting is attached. The event was structured around the following sessions and topics:

Session I: Review of official steps taken to address systemic issues

Session II: Financial crisis prevention (Part I)

- A. Managing external shocks
- B. Active policies to finance the productive economy

Session III: Managing risks

- A. Commodities: systemic issues
- B. Commodity price risk management

Session IV: Governance: African approaches to changing voice on the boards of the World Bank and IMF

Session V: Financial crisis prevention (Part II)

- C. The role of the private sector

Session VI: Credit during crisis

What follows is a brief description of the presentations and discussions during each one of the sessions with a clear focus on issues, proposals and recommendations. The meeting was held according to Chatham House Rules, i.e., neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed in any final official report.

Session I: Review of official steps taken to address systemic issues

The meeting started with a short overview by which focused on the link between trade and finance issues in support for development. Agricultural subsidies, low market access, tariff restrictions and resulting low customs revenues would force low-income countries such as Kenya into more domestic borrowing or raising tax rates. This often led to a crowding out of the private sector through sharply increased interest rates. The situation was worsened through low-income

countries' dependence on the extraction of commodities, which had suffered from a long-term decline in price. As a result, the current framework of the international financial institutions (IFIs) and the multilateral trading system needed to be reconstructed in order to allow for sufficient policy space in developing countries.

Following the presentation, a summary was made of the second multi-stakeholder consultation on systemic issues, which had been held in Lima, Peru from 17-18 February 2005.¹

Session II: Financial crisis prevention (Section A & B)

A. Managing external shocks

B. Active policies to finance the productive economy

A. Managing External Shocks

The session was opened by the presentation of a concrete proposal for an anti-shocks facility for all low-income countries. This facility would be comprehensive, and compensate all shock-induced shortfalls in GDP growth, budget spending, or foreign exchange (exports, imports, aid etc) for low-income countries. It would be much bigger than current facilities to provide adequate finance. The speaker emphasized that finance of such a facility would be based on grants from existing ODA allocations in order to avoid the increase of national debt burdens. Furthermore, any such facility should be fast-acting and draw on contingent funds that would be set aside for countries each year. It was also important that the facility would not be subject to any additional conditionality beyond that of having Poverty Reduction Strategy Papers (PRSPs). In order to ensure the effectiveness and speed of anti-shock financing, it would need to be set aside up front, as genuine financing against contingencies, rather than after the shock when its negative effects already had an impact on the economy. The issue of “moral hazard” that countries might rely on guaranteed external finance and not take serious steps to prevent or adjust to shocks would be prevented by the use of the funding for MDG-related budget spending and reserves enhancement, as well as the funding of specific measures to prevent future disasters and protect the poor.

Discussion

During the ensuing discussion participants proposed differentiating between policy-induced shocks and economic shocks as well as global and national ones. Some speakers highlighted the importance of the degree of correlation and duration of shocks for the construction of insurance mechanisms. In this regard they referred to recent research on Eastern Caribbean economies which laid out the possibility of fiscal insurance arrangements through cross-compensations. Through this mechanism volatility in fiscal accounts could be drastically reduced, where regional

¹ See previous report on multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office/UN DESA, at ANDEAN Community Headquarters in Lima, Peru from 17-18 February 2005.

fluctuations of output and government revenues were not significantly correlated.² It was suggested that this model might be transferable to other regions.

Some speakers recalled similar efforts and proposals such as the one presented. In particular, they mentioned the Common Fund for Commodities within UNCTAD's Integrated Program for Commodities, which was also based on the notion of independence or being uncorrelated. Overall, there was wide agreement that regional arrangements could be crucial instruments in dealing with shocks. Other forms of insurance mechanisms highlighted in the discussion included private sector emergency credit lines and bond swaps between developed and developing countries, whereby the latter group of countries could borrow money at interest rates lower than domestic rates.

B. Active Policies to Finance the Productive Economy

The opening speaker for this session considered the effects of alternative financial regimes on growth determinants. He suggested that the move away from directed credit and differential interest rates in many low-income countries resulted in a worsening of the deflationary stance through fiscal contraction and a tighter monetary policy framework associated with financial reform. Financial liberalization limited the poverty-reducing consequences of whatever growth occurred as the financial restructuring process and a rise in interest rates would lead to contraction in credit provision. Liberalizing the domestic financial sector and easing cross-border flows of capital were not the best options for developing countries in their early stages of development. These countries needed to adopt financial policies similar to those adopted by the present day developed countries when they were at similar stages of development. These more appropriate types of financial policies were development oriented, included a social banking approach through priority lending set by the state, ensured reasonable credit-deposit ratios and promoted a closer relationship between borrowers and creditors.

Discussion

During the discussion many participants underscored the importance of sufficient financial policy space for developing countries. On the question on how to ensure more balanced cash deposit ratios one speaker highlighted the US Community Reinvestment Act, which required banks, thrifts, and other lenders to make capital available in low- and moderate-income urban neighbourhoods. Many speakers emphasized the need to overcome information asymmetry in the financial sector and to reach out to rural people and women in particular. The debate also ventured into the IMF's role in financial sector reform. Participants criticized how the IMF would often disapprove of government subsidies for long-term financing in low-income countries, while at the same time calling for financial deepening. Many speakers emphasized the critical role development financing institutions could play in financial sector reform and lamented the imposed and often unsuccessful privatization of the latter in many African low-income countries.

² dos Reis, Laura." A Fiscal Insurance Proposal for the Eastern Caribbean Currency Union- A study for presentation to the XVIII G24 Technical Group Meeting", March 8-9, 2004 Geneva Intergovernmental Group of 24 (G-24).

Session III: Managing risks: commodities

- A. Commodities: Systemic Issues**
- B. Commodity Price Risk Management**

A. Commodities: Systemic Issues

The presenter called on participants to include issues related to commodities in the Financing for Development agenda.

While a decline in commodity prices would lead to a shortfall in export earnings and thus lower financial resources, there would be an even more important systemic aspect related to this issue. Indeed, the implications of sharp fluctuations in commodity prices had been viewed as a systemic concern by developed countries all along. Many measures had been taken by industrialized nations to reduce their dependence on commodities, in particular, through protectionist policies in the agricultural sector.

The speaker noted that the long term-decline in commodity prices and the associated decline in the terms of trade for developing countries implied a real resource transfer to consuming industrial countries. The speaker also lamented the adverse effects of short-term variability of commodity prices and the declining share of the commodity producers in the value chain. While in an ideal market setting the value chain would be determined through fair competition, in the real world the power to trade was determined by economic status. That resulted in unequal exchange and increased vulnerability of developing countries.

The presenter noted that during the 1960s and 1970s there was some considerable interest in establishing mechanisms to lower systemic risk of commodity price fluctuations for developing countries. One such agreement was the Lomé Conventions, to encourage African, Caribbean and Pacific (ACP) development, another one was UNCTAD's Integrated Program for Commodities. Yet, the interest in these mechanisms and political support has faltered in the last two decades while the problem persisted. The speaker concluded by pointing to the urgent need for an international forum to deal with the issue of commodities.

Discussion

Several participants pointed to the need for an international competition authority that could protect commodity producers as antitrust laws did domestically. Other speakers underscored the worrying phenomenon of a general decline in terms of trade for developing countries. Many goods in the manufacturing sector had been "commodified", i.e., they would be associated with the typical problems related to commodities, such as short-term price fluctuations, a long-term declining price trend, and a declining share of producers in the value chain.

It was pointed out that with the increased integration of developing countries into the global trade market the natural supply and demand hedge in local market was gone. While the

WTO was adamant about integrating low income countries into the international market it did not provide for a new price hedge to substitute for this loss. In a similar vein, participants criticized the tendency of developing countries to impose food safety standards on developing countries through integration into the global market. These standards would be distorting and discriminating and further worsen the situation of commodity-dependent economies. While many participants called for more regional trade arrangements, others warned that bilateral and sub-regional agreements would often undermine the WTO's most favored nation clause. The discussion also ventured into issues of supply-side constraints and removal of agricultural subsidies which were said to be major concerns of African economies.

B. Commodity Price Risk Management

The opening speaker focused his presentation on measures to hedge against short-term variability of commodity prices. The presenter distinguished between two types of measures. Firstly, governments could hedge their own government revenue through future contracts, and secondly, governments could help producers in hedging their commodity price risks. The presenter explained the potential benefits of government-sponsored risk management tools for local producers. Government authorities could distribute free put option contracts to local producers giving them the right, but not the obligation, to sell a specified amount of the underlying future contract at a specified price within a specified time. This way, farmers could effectively ensure themselves against sudden commodity price movements and deal with stable and predictable prices. The government in turn would roll-over the underlying futures at a regional or US futures market, which was likely to generate profit that could exceed transaction costs.

Discussion

During the following discussion, some participants raised concerns about the feasibility and applicability of this proposal for developing countries, underscoring the possible costs of hedging and the lack of adequate infrastructure in low income countries. There was wide agreement, however, on the potential benefit of lowering the short-term variability of commodity prices through effective hedging instruments. Participants concurred that for the proposal to work capacity building and technical assistance to promote the appropriate regulatory and supervisory infrastructure in the financial sector would be crucial.

Session IV: Governance: African approaches to changing voice on the boards of the World Bank and IMF

This session was on the record.

The session was opened by Mr. Cyrus Rustomjee, former Executive Director to the IMF, who focused on the need for improved representation of low-income countries, particularly in Sub-Saharan Africa, at the IMF. The presenter argued that developing countries now accounted for by far the largest client base of the institution and were the focus of the

significant majority of the IMF's policies. Hence, they should exert a proportionately larger influence over decision-making in the institution. Yet, voting strength was extraordinarily skewed in favor of creditors, who commanded 71 percent of the voting strength in the IMF Executive Board. This often resulted in poor decision-making for Sub-Saharan Africa. While approximately one fourth of the IMF's member countries were in sub-Saharan Africa, these countries shared a combined voting power of only 4.4 percent and forty-four Sub-Saharan countries were presented by only two Executive Board seats.

Unbalanced representation was a problem as it bred inefficiency through inappropriate program design that failed to take account of the specific circumstances of member countries. Representation arrangements needed to be altered in a manner that strengthened the debtors' decision-making capacity. Among the various potential options to achieve a better balance, the presenter highlighted an increase of basic votes, GDP calculations based on purchasing power parities, a unified European vote as well as more global financial resources allocated to human resource development (to increase negotiating skills in low-income countries), capacity building, and technical assistance.

Discussion

There was wide agreement that the democracy deficits highlighted by the presenter had to be overcome. During the discussion several participants went even further and questioned the overall benefits of low-income countries' membership in the IMF, and explored the merits of countries leaving the IMF. Others warned, however, that the IMF's "gatekeeper role" would preclude this option. Leaving the IMF would effectively amount to being excluded from the world economy. Many speakers stressed the need for more accountability on the side of the IFIs and highlighted the need to increase the transparency of their decision-making processes. In order to achieve a more equitable distribution of voting shares it was suggested to strengthen those variables in the quota formula that would indicate the need for resources, such as holding of foreign currency denominated debt and net share of FDI inflows among developing countries. On a more general note, participants concurred that a successful strategy to overcome the deficiencies discussed should be based on efficiency rather than moral arguments.

Session V: Financial crisis prevention (Section c)

C. The role of the private sector

The session was opened by two short presentations of private sector representatives who highlighted some of the major challenges low-income countries businesses faced during times of financial crises. In this regard the speakers referred to a lack of access to finance for small and medium-sized enterprises and high interest rates, supply-side constraints, excessive inflation and a weak and non-supportive public sector as the major impediments to success.

Furthermore, many low-income countries had no appropriate regulatory and supervisory regimes, which would be the basis for a functional domestic financial sector. Without the appropriate infrastructure it was extremely difficult to increase the access of businesses to sources of capital and further develop the domestic capital market. For instance, establishing stock markets had turned out to be an unsuccessful undertaking in Sub-Saharan Africa, as very

few companies were listed and most of them were not domestic ones. On a more positive note, the presenters highlighted domestic development financing institutions as a promising alternative for providing much needed capital funds to the private sector.

Discussion

During the discussion many speakers stressed that a diversification of funding sources through a robust expansion and deepening of the domestic financial sector would be the road to success. Increasing regulatory capacities was a crucial prerequisite for financial deepening. Several participants also warned about the detrimental effect of high debt servicing payments and increasing debt stocks on the fundraising abilities of domestic capital markets. There was wide agreement on the potential benefit of regional financial arrangements and regional coordination in preventing crisis. One concrete proposal was to establish regular regional meetings of financial regulators. This could be coordinated by existing institutions with proven capacity and expertise, such as the Financial Stability Forum. Another concrete proposal was to better steer interest rate expectation through the introduction of a federal fund rate by the central bank, following the example of the US.

Session VI: Credit during crisis

This session opened with an overview of various existing programs and proposals to provide resources in times of crisis.

While all described programs fell under the category of mitigating rather than preventing problems there were some important distinctions. Some mechanisms were at the national level through various forms of domestic savings or hedging and others would be international programs. Another key distinction was that between programs designed to provide credit in the event of a natural disaster and those designed to respond to a commodity price shock or other economic disruptions. Among national programs to dampen disruptions the speaker referred to buffer stocks (stabilization fund, savings fund), commodity credit corporations and massive foreign reserve hoarding. Under the category of international programs, the presenter listed natural disaster relief funding and commodity price shocks facilities. He concluded by explaining some international financial markets instruments such as catastrophe bonds, catastrophe futures and options, weather derivatives, structured foreign reserve funds, options on credit as well as commodity-indexed bonds and commodity-linked bonds.

Discussion

Participants underlined the importance to distinguish the nature of shocks, in particular to differentiate between exogenous and endogenous shocks. It was pointed out that most low-income countries had no access to international capital markets limits and therefore only very restricted potential for countercyclical policy measures. Their options were further reduced by the reliance on IMF loans, which would be below market rates but would curtail developing countries' policy space. Several speakers called for more grant financing to lower the debt stock

in low-income countries. It was suggested that in times of crisis there was a need for orderly debt work out mechanisms and efforts to develop such a device should be strengthened. Other measures of crisis prevention mentioned included emergency loans for the private sector and bond swaps between developed and developing countries as described above (Session II a).

Conclusion

The program concluded with a summary of the highlights of discussions from the two days, and thanks to the organizers and to the participants, especially to those who had travelled great distances to participate.