

Interim Report and Recommendations

On “Addressing Systemic Issues”, Section F Of the Monterrey Consensus adopted at the International Conference on Financing for Development Monterrey Mexico, March 2002

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**New Rules for
Global Finance**

TABLE OF CONTENTS

I. Introduction	1
A. Goal of the Multi-Stakeholder Consultations on Systemic Issues.....	1
B. New Rules for Global Finance Coalition.....	1
C. Assessment of the <i>Status Quo</i>	2
II. Recommendations: Preventing Financial Crises	4
A. Prudential Regulation of Financial Markets.....	4
B. Counter-Cyclical Policies	5
C. International Lending in Local Currency.....	6
D. Commodity Price Risk Management.....	7
III. Recommendations: Healthy Financing for the Real Economy--Insurance Against Financial Crises.....	9
A. Taxes, the Real Economy and Financial Crises	9
B. Policies to Support the Productive Economy, National Development Banks	10
C. Micro-Finance	11
IV. Recommendations: When Crises Strike	13
A. A Comprehensive Framework for Sovereign Debt Restructuring in Middle- Income Countries	13
B. IMF: Liquidity in Times of Crisis.....	14
C. Responding To Exogenous Shocks	16
V. Governance	18
A. Governance of the World Bank and the International Monetary Fund	18
B. Governance of Financial Agenda and Standard-Setting Bodies	20
VI. Final Recommendations.....	23

I. INTRODUCTION

A. GOAL OF THE MULTI-STAKEHOLDER CONSULTATIONS ON SYSTEMIC ISSUES

The New Rules for Global Finance Coalition has worked for the past year on Multi-Stakeholder Consultations on Systemic Issues in order to promote the implementation of this Section (F) of the Monterrey Consensus Document. In each of the four sessions—in Washington, DC at the IMF; in Lima, Peru; in Nairobi, Kenya; and in New York City at the United Nations—New Rules has worked with other multi-stakeholder participants to identify well-researched and politically viable policy proposals that could leverage significant change toward the goals articulated at the Monterrey Conference. Each session followed the same core agenda: 1) Assessment of official steps taken to prevent and reduce global financial crises; 2) Policies to prevent financial crises; 3) Policies to provide credit to countries in situations of financial crises; 4) Mechanisms to manage risks arising from financial crises; 5) Governance of the IMF, World Bank, and other financial rule-making bodies, including the Bank for International Settlements, the Financial Stability Forum, and the Basle Committees. The original plan was set forth at the UN on July 21, 2004. Each step of the process has been documented on the New Rules website and through a link on the UN Financing for Development (FfD) Office website: www.new-rules.org and www.un.org/esa/ffd.

The New Rules for Global Finance Coalition expresses its deep appreciation to all who participated in these consultations. Each person shared deeply and generously his/her analysis, insights, and values. The recommendations set forth here are exclusively those of the Coalition. As agreed in the terms of reference for the consultations, these recommendations do not represent any consensus or majority position among participants. Nor can they begin to capture the rich and varied dialogue of those gatherings.

The Coalition also thanks the co-conveners in Lima, the Asociacion Latinoamerica de Organismos de Promocion de Desarrollo (ALOP), and in Nairobi, the Kenya office of the Southern and Eastern Africa Trade, Information, and Negotiations Institute (SEATINI), and the Friedrich Ebert Stiftung. None of this would have been possible without the financial support of the Open Society Institute, the Swedish Foreign Ministry, the Commonwealth Fund, the Friedrich Ebert Stiftung, the UN Foundation, and of course the excellent staff of the UN FfD Office. The Coalition enjoys core funding from the Ford Foundation.

B. NEW RULES FOR GLOBAL FINANCE COALITION

The New Rules for Global Finance Coalition is a gathering of non-governmental organizations and academics which started in 1999. Because of their commitment to greater economic justice, members volunteer their time and talent to identify and promote viable policy options that can prevent financial crises, or mitigate their effects, especially for poor people and poor countries. The members believe that financial stability, equitable and environmentally sustainable growth, when combined with transparent and accountable governments and public and private financial actors, can be powerful means toward poverty eradication. The Coalition has been engaged with

the Financing for Development process since 2000. Because of the expertise that the Coalition brings, and its long-standing commitment to FfD, the UN Financing for Development Office invited the Coalition to serve as the civil society convener of this series of multi-stakeholder consultations.

C. ASSESSMENT OF THE STATUS QUO

The problem: The financial system is vast, complex, and imperfect, fraught with myriad problems. Before launching these consultations, New Rules identified core problems to guide its analysis and prescriptions.

1. The current financial system is too often characterized by instability and uneven distribution of capital. There are cycles of boom and bust, of financial surges and droughts, over and under valuations of securities and of currencies. Markets can be risk averse and risk loving. These fluctuations can impede development and worsen poverty, particularly for low-income, commodity dependent countries.
2. For too many developing and emerging market countries, international financial capital flows at times have also been insufficient to promote sustained development. Also, they frequently lack appropriate prudential regulations, especially in areas such as hedge funds and over the counter derivatives.
3. The governance structures of global financial rule-making bodies do not conform to contemporary standards of legitimacy, thereby undermining their effectiveness. While virtually all countries are members of the IMF and World Bank, they are effectively organized and led by the developed countries. In fora such as the Bank for International Settlements (BIS), the Financial Stability Forum (FSF), and the Basel Committees, there is no pretension of global membership or even representation, although their rules impact all countries. In addition, private standard setting bodies, such as those for auditing and accounting, also formulate international policies. Governance is an issue of justice as well as effectiveness.

Progress to date: Official steps to promote global financial stability, adequate investment finance, and greater equity in governance of rule-making bodies have been disappointing. Reforms have focused excessively on changes to financial sectors in developing countries, while insufficient attention has been given to reforms of developed countries' financial markets. The IMF lacks adequate and appropriate resources and facilities to respond promptly to financial crises.

D. REPORT'S RECOMMENDATIONS

This report contains New Rules' recommendations of concrete, viable prescriptions that, when implemented, will contribute toward more stable, equitably distributed and sufficient sources of financing for development, as well as improved governance of global financial rule-making bodies.

Some readers may desire more in-depth discussion of the recommendations than can be provided here. Therefore, each subsection identifies selected background reading which can be found in the footnotes. Most of these readings can be found at the New Rules website: www.new-rules.org

Some recommendations require action by the UN and the global community of nations. Many others can be implemented by individual countries acting alone. These recommendations do not provide a plan for Utopia. They are part of a process of “radical incrementalism”¹ that will bring the world closer to realizing the vision of Monterrey.

¹ This approach was described and recommended by Francisco Sagasti, Keith Bezanson, and Fernando Prada, in The Future of Development Financing: Challenges, Scenarios and Strategic Choices (Institute of Development Studies, University of Sussex, for the Global Development Studies Series, Expert Group on Development Issues, Ministry of Foreign Affairs, Government of Sweden, January 2005).

II. RECOMMENDATIONS: PREVENTING FINANCIAL CRISES

53. ...We also underscore our commitment to sound domestic financial sectors, which make a vital contribution to national development efforts, as an important component of an international financial architecture that is supportive of development.

Source: Monterrey Consensus Document.

Despite the severity and frequency of financial crises, not enough has been done to design and implement preventative measures. Pursuing good macro-economic policy is not enough, and the policy of opening financial markets to international transactions before first establishing proper prudential regulatory measures and enforcement authorities has proven disastrous. This challenge of posing effective and viable remedies was addressed at each consultation. The discussions and proposals in the multi-stakeholder consultations on the issue of crisis prevention focused largely on the following four areas: 1) The need for domestic prudential regulation of financial markets and especially derivatives; 2) The need for developing countries to be able to implement counter-cyclical policies; 3) The wisdom of borrowing in local instead of hard international currencies; and 4) The challenge to reduce commodity price volatility by using market tools, especially derivatives.

A. PRUDENTIAL REGULATION OF FINANCIAL MARKETS

Prudential regulations can improve the solvency and viability of financial institutions, as well as enhance the efficiency, dependability and stability of financial markets and the overall economy. This latter point is sometimes overlooked. The Standards and Codes project of the International Monetary Fund (IMF), World Bank,² Bank for International Settlements (BIS) and Financial Stability Forum (FSF), amongst others, focuses its efforts primarily on accounting, governance and capital adequacy of financial institutions in developing and emerging market countries. It does not adequately address issues such as how they act as dealers in over-the-counter (OTC) markets for foreign currency, securities, derivatives and repurchase agreements. Derivatives are treated primarily as a matter of credit risk, and not market and liquidity risk. Transparency is praised but not enforced with regard to reporting requirements for market prices, trading volume, open interest in the market and large trader position. Proper market surveillance by regulatory authorities is not possible without such information. And without such transparency and surveillance, investors cannot be assured that prices are fair and honest. Liquidity is praised by these standards, yet regulators require that dealers in OTC markets maintain binding quotes throughout the trading day. A notable exception is for primary dealers in US Treasury securities markets where such market-making activities are required as a condition for being registered as a primary dealer. The result for the US is to ensure market liquidity throughout the trading day.

In addition to the need to apply prudential regulations to markets and financial transactions and not just financial institutions, their application to developing countries should also take into consideration the intense impact of macro-economic risks on domestic financial institutions and markets.

² The IMF and World Bank are often referred to jointly as the Bretton Woods Institutions since they were both founded at the Bretton Woods Conference in 1944.

New Rules recommends:

1. Designing and implementing prudential regulations for financial markets and financial institutions in order to enhance transparency, govern risk taking and foster orderly marketplaces. This should reduce the build up of exposures to risks in such areas as foreign exchange, maturity mismatch, liquidity, and concentrated credit exposures. Especially important is the application of prudential regulation to derivatives markets, which are growing rapidly in the developing world.

B. COUNTER-CYCLICAL POLICIES³

The objective here is to enable developing countries to avoid pro-cyclical monetary and fiscal policies, and create policy space for counter-cyclical policies. Too often this is not an option for developing countries because their exchange rate policy ties up their monetary policy in a pro-cyclical fashion, and their more fragile tax base and foreign borrowing abilities result in pro-cyclical fiscal policy.

One policy tool that can help to create useful policy space is the adoption of price-based capital controls – especially the unremunerated reserve requirement like those adopted by Colombia, Chile and now Argentina – which can contribute toward preventing exchange rate appreciation during the boom period and thereby free up monetary policy for other objectives such as expansionary policy in the event of an economic contraction.

Another policy tool involves the use of prudential regulation. These measures aim primarily at the safety and soundness of financial institutions and market activity. They can also have the effect of constraining certain types of risk exposures and thereby creating more latitude within which to conduct counter-cyclical policy.

However some prudential measures can act in a pro-cyclical way. These include the timing of accumulating banks' loan-loss reserves which often occurs once the economy is in a recession or crisis and thus reduces the capacity of banks to increase credit so as to move into a recovery. Capital requirements can also act pro-cyclically if the market value of regulatory capital or the measurement of credit risk exposure moves in a cyclical manner. Another example is the collateral management policy of OTC derivatives dealers who require no collateral up front but then require rapidly increasing amounts once their counterparty gets into trouble – this serves, in effect, as a crisis accelerator. Moreover the tendency to adopt new and stronger prudential measures during a downturn also has the pro-cyclical effect of dampening any recovery.

In contrast, forward looking prudential regulatory provisions interject counter-cyclical forces into the financial sector. Examples of this include requiring that funds for loan-loss be put aside at the beginning of the loan and that collateral for OTC derivatives be posted in sufficient amounts in the beginning – just as exchange traded futures and options require.

³ Jose Antonio Ocampo, "Capital-Account and Counter-Cyclical Prudential Regulations in Developing Countries," Prepared as part of the UNU/WIDER-ECLAC Project on Capital Flows to Emerging Markets Since the Asian Crisis, February 2003.

Included under prudential regulation is the government's own debt management policy. Developing longer maturity fixed-rate debt instruments can help prevent the government's interest payments and funding requirements from generating pro-cyclical fiscal effects during a crisis.

New Rules recommends:

2. Use prudential regulation and capital controls in order to facilitate the use of counter-cyclical monetary and fiscal policy by developing country governments.

C. INTERNATIONAL LENDING IN LOCAL CURRENCY

The buildup of enormous amounts of debt denominated in major currencies – most of all the US dollar – poses the largest single source of instability in the developing world. These large exposures to foreign exchange rate and interest rate risks make developing countries more vulnerable to foreign shocks as well as disturbances in their own economies. The results show that the hard currency debt has acted as catalyst and fuel for most of the financial crises over the past two decades.

One big step toward solving this problem is for developing countries to avoid foreign currency exposures by borrowing in their own currencies (and accordingly for investors to lend in those local currencies). The benefits to the developing countries are clear: substantially lower foreign exchange exposures; better credit ratings; more seigniorage; and improvements in the efficiency of local securities markets.

The benefits to investors are great but perhaps less obvious. By employing the risk management technique of diversification in order to create portfolios of low correlated local-currency denominated government debt securities, investors can obtain a return-to-risk that competes favorably with security indexes in the major capital markets.

The gains from diversification are based on the low degree of correlation between the returns of the various local currency assets. While the rate of return on any one local currency asset may be highly volatile – thus creating a poor risk-adjusted rate of return – the combination of highly volatile but lowly correlated returns produces a portfolio with returns that are the average of the returns in the various currencies but with a variance that is substantially lower. One study found shows that such a portfolio had lower volatility than the S&P500 and EMBI+ (dollar denominated emerging market debt) over the period from 1992 to 2004.⁴

⁴Randall Dodd and Shari Spiegel, "Up From Sin: A Portfolio Approach to Financial Salvation," G24 Discussion Paper, January 2005. Available at www.g24.org

New Rules recommends:

3. In order to prevent buildup of foreign exchange rate risk and to encourage improvements in local financial markets, promote international lending in local currencies and promote international investing through the use of diversified portfolios of local currency assets.

D. COMMODITY PRICE RISK MANAGEMENT⁵

37. *..It is also important to empower developing country commodity producers to insure themselves against risk, including against natural disasters....*

Source: Monterrey Consensus Document

Many developing countries are highly dependent upon the price of a few commodities for a majority of their export earnings. This situation often results in a high degree of correlation between the prices of those commodities and their export earnings, GDP and government revenues. Through this macro-economic impact, commodity price risk has profound consequences for governments, individual producers and consumers in developing countries.

This has long been recognized as a serious problem, as "fluctuations in the volume and value of foreign trade tend to be proportionately more violent in that of underdeveloped countries and therefore a fortiori also more important in relation to national income."⁶ The World Bank concurs. "The fact that commodity prices have become more volatile since 1973 has hit low-income countries the hardest. This is because they tend to rely on commodity price exports for a larger proportion of their export earnings. Research shows that downturns in commodity prices tend to vary in length but can last several years."⁷

The consultation addressed the problem of commodity price volatility and expressed concerns about both the long-term and short-term dimensions of the problem. This reflects a long-standing awareness of the problems, as expressed years ago by the noted economist Hans Singer. "The case for stabilization of terms of trade ... has, it seems to me, nothing to do with the existence of their secular trends but a great deal to do with their large and extremely damaging cyclical and short-term fluctuations. Long-run trends are if anything an argument against stabilization of terms of trade, as I believe most sensible people agree. But the violent cyclical and short-term fluctuations certainly add to the underlying difficulty discerned by Prebisch and others."⁸

New Rules recommends that developing country governments hedge their budget revenue's exposure to commodity price risk. There are a variety of derivative instruments available on exchanges (mostly futures and options) or in over-the-counter markets. While most trading on

⁵ Randall Dodd, "Protecting Developing Economies From Price Shocks," Financial Policy Forum Special Policy Brief, September 2004. Available at www.financialpolicy.org

⁶ H. W. Singer, "The Distribution of Gains Between Investing and Borrowing Countries," *American Economic Review*, May 1950, pp. 473-485.

⁷ World Bank "DevNews" item from March 5, 2004.

⁸ H. W. Singer, "Comment: The Terms of Trade and Economic Development," *The Review of Economics and Statistics*, Vol. 40, No.1, 1958, pp.85-90.

derivatives exchanges is in near-term contracts, these can be rolled-over in order to provide an effective, low-cost hedge over a longer period of time. This approach has its skeptics who are worried about the risks associated with the roll-over process. Contrary to this skepticism, the experience of the private sector is that they have successfully employed this hedging strategy to manage a vast array of risks for over a hundred years. While there are costs and risks to hedging, they are small and manageable in comparison to the risk of not hedging.

Another part of this recommendation supports efforts by developing country governments to provide risk management tools to their small producers. This can entail offering free, non-transferable put options to farmers in order for them to benefit from some price certainty; and for their part the government should hedge their exposure from these written put options by selling futures or using OTC derivatives contracts.

New Rules recommends:

4. Promoting better commodity price risk management by supporting government efforts to hedge the correlation between budget revenues and commodity price fluctuations and providing simple and affordable risk management to small, local producers.

III. RECOMMENDATIONS: HEALTHY FINANCING FOR THE REAL ECONOMY--INSURANCE AGAINST FINANCIAL CRISES

Eradicating poverty requires attention beyond the financial sector, indeed, it requires putting the financial sector to work at the service of the real economy, and thereby to meet the Millennium Development Goals. Throughout these Multi-Stakeholder Consultations, the focus remained on this central goal. Here New Rules recommends: 1) Greater international tax cooperation to enable developing and emerging market countries to keep domestic wealth at home, and through domestic taxes, provide more resources for development; 2) Ensuring developing and emerging market countries sufficient policy space to design their own path to development; and 3) Designing financial regulation for the micro-finance industry that will ensure its growth and integrity.

A. TAXES, THE REAL ECONOMY AND FINANCIAL CRISES⁹

64. To strengthen the effectiveness of the global economic system's support for development, we encourage the following actions:...

- *Strengthen international tax cooperation, through enhanced dialogue among national tax authorities and greater coordination of the work of the concerned multilateral bodies and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition.*

65. We commit ourselves to negotiating and finalizing as soon as possible a United Nations convention against corruption in all its aspects, including the question of repatriation of funds illicitly acquired to countries of origin, and also to promoting stronger cooperation to eliminate money-laundering....

Source: Monterrey Consensus Document.

It is estimated that there is currently \$11.5 trillion dollars held in OECD and EU financial centers, and other onshore and offshore financial centers, but undeclared in the respective country of residence.¹⁰ While most of these undeclared funds come from developed countries and transnational corporations, a significant portion originate in developing countries. This is a global problem which costs governments around the world about \$250 billion in lost tax revenue every year. This capital flight is facilitated by bank secrecy and other confidentiality laws in those financial centers, and also by the tax free treatment on bank deposits and other interest-bearing investments in those financial centers.

Restricting bank secrecy and other confidentiality laws in tax matters in those financial centers, and increasing exchange of tax information between governments (in particular the automatic exchange of information), would significantly diminish such capital flight and the resulting tax evasion. This would enable developing countries to retain more resources and enable governments to derive greater tax revenues and mobilize greater resources for development.

⁹ Sony Kapoor and Meenoo Kapoor, Section on Plugging the Leaks in "Toward the MDGs, *What needs to be done?*", An Issues Paper and Call to Action for Heinrich Boell Foundation, United States, May 2005.

¹⁰ "Briefing Paper: The Price of Offshore" Tax Justice Network, March 2005.

This would also permit a more transparent and better regulated international financial system, and help reduce corruption, money laundering, terrorist financing, and other frauds.

New Rules recommends:

- 5. Governments should implement and intensify the exchange of information in tax matters between governments (particularly the automatic exchange of information), overriding bank secrecy and other confidentiality laws in tax matters.**
- 6. OECD countries should comply with the same rules and standards that the OECD requires of non-OECD jurisdictions regarded by the OECD as tax havens.**
- 7. Developing country jurisdictions that currently rely on bank secrecy and tax free treatment for revenue should be assisted to shift to other revenue producing activities for development.**

B. POLICIES TO SUPPORT THE PRODUCTIVE ECONOMY, NATIONAL DEVELOPMENT BANKS¹¹

53. ... We also underscore our commitment to sound domestic financial sectors, which make a vital contribution to national development efforts, as an important component of an international financial architecture that is supportive of development.

56. We stress the need for multilateral financial institutions, in providing policy advice and financial support to work on the basis of sound, nationally owned paths of reform that take into account the needs of the poor and efforts to reduce poverty, and to pay due regard to the special needs and implementing capacities of developing countries and countries with economies in transition, aiming at economic growth and sustainable development....

Source: Monterrey Consensus Document.

Increasing broad-based growth and productivity rates and reducing poverty call for the development of a financial sector capable of supporting the needs of the productive economy. The market has an important role to play in determining the pattern and allocation of investment. However, as noted in a growing body of literature, the market alone cannot ensure such pattern and allocation that are optimal to secure and maintain a desired profile of production. One reason for this is the existence of market failures (actually, more common in financial than in commodity markets). Over reliance on the market can also lead to undesirable levels of credit concentration. It can hamper credit whose collective or social rate of return (such as innovative activities, small farm owners, small and medium enterprises) is higher than the rate of return that could motivate individual market participants. In fact, modern institutional economics posits that the market is always a construct with explicit or implicit boundaries set by social and political norms, objectives and interests mediated by the state. The only remaining question then is not whether but how intervention should be implemented.

¹¹ C.P. Chandrasekhar, "Thematic Summary Report: Financial Liberalization," Independent Report, Commissioned by UNDP, 2004. Available at www.new-rules.org

The state can choose from a range of institutional frameworks to influence the pattern of investment. It can: a) become an actor in the financial market through its own participation in providing credit, b) regulate the private/ commercial share of credit, and c) establish development finance institutions.

A menu of policy instruments includes: a) directed and subsidized credit, b) partial subsidies on credit insurance premiums or partial guarantee funds, c) differential and preferential interest rates, d) ceilings and other measures aimed at affecting the deposit-credit ratio, e) state direct equity investments, and f) the establishment of state-backed development finance institutions.

Many of these policy instruments, far from being new, were used, and remain in use, by today's developed countries when they were at earlier stages of their development process, as well as by some late developers. One example is the German reconstruction credit bank. Another example is the US Community Reinvestment Act, whereby banks, thrifts and other lenders are required to make capital available in low and moderate-income neighborhoods. The East Asian countries achieved sustained rates of growth and development over long periods of time using similar policies. Today, however, developing countries have been required to dismantle many of these same instruments in the name of financial liberalization.

New Rules recommends:

8. Governments should use, in an appropriate mix, policy instruments to ensure the availability of long-term credit, on affordable terms, to support the productive economy.

9. Establishing domestic and public development finance institutions should be encouraged and supported by international financial institutions, donors, and when feasible, the private sector, including through the provision of technical assistance and equity investment.

C. MICRO-FINANCE

18. Microfinance and credit for micro-, small and medium-sized enterprises, including in rural areas, particularly for women, as well as national savings schemes are important for enhancing the social and economic impact of the financial sector.

Source: Monterrey Consensus Document.

There has been a lot of promise and praise piled on micro-finance. It appeals to many different people and perspectives through its potential to reduce poverty through markets mechanisms, economic incentives, community participation and group discipline. It also teaches financial literacy and encourages small entrepreneurs to boot-strap themselves out of poverty. The donor community and the for-profit private sector have been moving into this area for years. Even major financial institutions such as Citigroup have embarked on their own micro-lending ventures. Within the context of the UN Decade for the Eradication of Poverty, the UN General Assembly designated the year 2005 as the International Year of Microcredit stating that the Year

will be an important opportunity to give impetus to micro-finance programs throughout the world. It is the anti-poverty policy that costs governments virtually nothing.

One point of praise that has received less attention is its potential to provide credit to small enterprises during times of economic stress or crisis. Micro-finance institutions have a different business model than banks. They do not have any large single credit exposures, but instead a multiplicity of small ones. The loans are short-term and the ability of micro-borrowers to repay is less correlated with the overall state of the economy. Moreover, the funding for micro-lending is more long-term – either donor capital, retained earnings or more recently private capital issuances – and is thus less sensitive to macro-economic disruptions than bank deposits or interbank loans. Together these features help make micro-lending a non-cyclical activity.

While the popularity and praise have merit, they should not drown out the need for appropriate policies to help ensure that micro-finance proceeds with safety and soundness and in the right direction. These new and emerging financial services deserve a prudential regulatory framework that suits their special features. Many micro-lending institutions do not accept deposits or raise capital through public capital markets, and so these firms need less prudential treatment than those institutions that do. Many micro-lending institutions do not make or receive cross-border transactions (except donor capital), and so these firms need less prudential treatment and suspicious transaction surveillance than those that do. In general they do not play the same role of making and clearing payments for goods, services and financial transactions in the economy that banks do. Their regulation should reflect this different role. Lastly, most micro-lending institutions never engage in transactions larger than \$1,000 or even \$500, hence these firms should be exempt from concerns about money laundering and terrorist financing.

So far, the regulatory interest in the micro-finance sector has focused on removing anti-usury laws that place a ceiling on interest rates. This effort should not be used as a stalking horse for wider financial deregulation. Moreover, micro-finance should be subject to anti-predatory lending laws, truth in lending laws and other such consumer protections. As micro-finance organizations grow in size and scope, they should fall under prudential regulatory rules and supervision like the credit unions and savings associations that have preceded them. New Rules recommends:

10. Micro-finance institutions need and deserve a prudential regulatory framework that suits their special characteristics and that protects the public interest from financial instability, fraud, and predatory lending.

IV. RECOMMENDATIONS: WHEN CRISES STRIKE

While the emphasis of the Consultations was on crisis prevention, financial crises—from myriad causes—are likely to strike developing and emerging market countries. Recognizing this reality, New Rules proposes three areas for action: 1) Establishing a comprehensive framework for sovereign debt restructuring, beginning with middle-income countries; 2) Ensuring that the IMF has the resources and flexibility to serve as a lender of last resort; and 3) Providing a grant facility for the poorest countries when they are beset by commodity shocks.

A. A COMPREHENSIVE FRAMEWORK FOR SOVEREIGN DEBT RESTRUCTURING IN MIDDLE-INCOME COUNTRIES¹²

60. To promote fair burden-sharing and minimize moral hazard, we would welcome consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner.

Source: Monterrey Consensus Document

The lack of an orderly debt restructuring mechanism for middle-income countries not only generates significant costs, it also endangers the stability of the international financial system. Existing ad hoc machinery for debt workouts are disorderly, delayed and inefficient, thereby generating excessive costs for both debtors and creditors. They are also a source of contagion for all emerging market countries. The growing use of Collective Action Clauses for bond debts does not involve adequate aggregation of different debt instruments; the business sector's voluntary code of conduct can not solve collective action problems since it lacks binding principles.

Insolvency procedures such as the Sovereign Debt Restructuring Mechanism (SDRM) of the IMF or the proposal by Kunibert Raffer modeled after Chapter 9 of the US bankruptcy code would provide a legal framework for dealing with over-indebted countries. However, major obstacles thwart progress toward debt restructuring: financial market investors and developing countries' governments declined to give the IMF, itself a major creditor, a leading role as a debt negotiator through the SDRM; political will is lacking to translate new legal measures on international insolvency procedures into national legislation.

The multi-stakeholder consultations presented a new proposal for an International Debt Framework (IDF) that opens a middle ground between legally binding insolvency procedures and a voluntary code of conduct. The mechanism would be initiated by the Group of 20 of Finance Ministers from developed and developing countries. It would be available to all middle-income countries and not limited to G20 member states. To ensure predictability for international creditors the proposed mechanism would provide a general set of principles such as

¹² Kathrin Berensmann and Frank Schroeder, [A Proposal for a New International Debt Framework \(IDF\) for the Prevention and Resolution of Debt Crisis in Middle-Income Countries. A Proposal for a New International Debt Framework \(IDF\) for the Prevention and Resolution of Debt Crisis in Middle-Income Countries,](http://www.new-rules.org) February 2005. Available at www.new-rules.org

those embodied in the proposal for a code of conduct. The IDF would have two functions: crisis prevention and crisis resolution. The new framework could contribute toward crisis prevention through an IDF secretariat, where permanent debtor-creditor dialogues could take place, along with transparent provision of timely information on emerging market debts. As a second step, an IDF Commission could facilitate an orderly debt-restructuring mechanism for a financially distressed debtor, convening representatives from the debtor, private creditors, multilateral lenders and sovereign creditors. In contrast to other insolvency proposals such as the SDRM, the underlying framework for the IDF is not statutory and the mechanism would aim for a coherent and comprehensive restructuring of all types of debt. The IDF Commission would decide on the amount of financial support needed, along with the economic adjustment path that could guarantee long-term debt sustainability.

While many participants in the multi-stakeholder consultation acknowledged the importance of a new insolvency procedure for middle-income countries concerns were addressed towards its political feasibility. Some concerns referred to whether the private sector and developing countries would be supportive for such a mechanism and if the G20 would be the appropriate forum to initiate the IDF. The discussion clarified that first, in-depth analysis and risk assessments on emerging market debt markets were sorely lacking, and second, the absence of regular dialogues between debtor and creditors was a major obstacle to crisis prevention. Hence, the IDF Secretariat could serve an important function by providing technical expertise and convening regular dialogues. Moreover, the unilateral stance of Argentina in its recent debt negotiations with its creditors has increased the private sector's interest in new solutions and eased the fear of developing countries that a new international debt restructuring mechanism might delay restoration of access to capital markets. The discussion clarified further that the proposal does not envision the upgrading of the economic decision-making capacity of the G20. However, because of the rejection of the SDRM in the IMF and the lack of political consensus in other multilateral organizations, the framework could be initiated on the level of finance ministers in the G20. It was also noted that as soon as a new International Debt Framework was established, it would be necessary to refer to the rules of the IDF in contracts between debtors and creditors such as bond contracts and investment treaties to prevent individual creditors from resorting to litigation.

New Rules recommends:

11. Pursuing the development of a new mechanism, the International Debt Framework (IDF), to improve crisis prevention and resolution in the international financial system. The mechanism could be initiated by the Group of 20 Finance Ministers from developed and developing countries. After its establishment, the IDF should not be limited to G20 member states.

B. IMF: LIQUIDITY IN TIMES OF CRISIS¹³

59. Noting the impact of financial crisis or risk of contagion in developing countries and countries with economies in transition, regardless of their size, we underline the need to ensure that the international financial institutions,

¹³ Ariel Buira, "The IMF at Sixty: An Unfulfilled Potential?", *The IMF and the World Bank at Sixty*, (London: Anthem Press, 2005).

including the International Monetary Fund, have a suitable array of financial facilities and policies. The International Monetary Fund has a range of instruments available and its current financial position is strong. The contingent credit line is an important signal of the strength of countries' policies and a safeguard against contagion in financial markets. The need for special drawing rights allocations should be kept under review....

Source: Monterrey Consensus Document.

Like their domestic counterparts, international financial markets are more stable when there is an adequate lender of last resort. The IMF serves this role in international markets, but its resources and policies have proven inadequate in some circumstances. The magnitudes of recent financial crises have shown that more loanable funds are needed to restore market order and commence economic recovery. In a different vein, the lack of participation in the IMF's contingency credit facilities has shown them to be policy failures in providing credit to countries faced with natural disasters or commodity price shocks.

Developing countries pay a heavy price for these short-comings. Recovering from crises is all the more slow and burdensome without adequate resources to promote new investment and growth. Absorbing natural disasters and price shocks is similarly more costly when there is a lack of resources for counter-cyclical measures.

In addition, developing countries are harmed by not having access to sufficient emerging credit to help stem incipient capital outflows, speculative attacks on their currency or other financial disruptions.

In some cases the burden shows up as accumulated foreign reserves of major currencies – especially the US dollar -- which are a costly form of protection against financial crises that could be more productively employed elsewhere in developing economies.

The situation is even more severe for the group of Low Income Countries (LICs), who, unable to borrow in their local currencies, have to borrow hard currencies on the international market or from international financial institutions to finance fiscal and current account deficits. Therefore, appropriate facilities and instruments for developing countries for the provision of foreign-exchange liquidity are an important element in economic development.

The consultations discussed the possible use of additional allocations of Special Drawing Rights (SDRs) to increase available credit to developing countries. This would allow countries to build reserves without any hindrance for public spending.

In contrast to the expectation that the private markets would always supply global liquidity, Article XVII of the IMF's Articles of Agreement empowers the IMF to create liquidity needed to accomplish its purposes. The SDRs were designed to serve that end. The quota revision should bring resources back to the size set in 1944, where Fund resources were roughly 58 percent of world trade. They currently stand at approximately 4 percent.

In addition, the Fund should expand the size of the first tranche of an arrangement, which now stands at one-third of the total amount of the arrangement, in order to better accommodate borrowing needs at the onset of a crisis. Further, the IMF should create a new contingent credit

facility to improve on short-comings with their Contingency Credit Line and Compensatory Financing Facility.

New Rules recommends:

12. The IMF should increase the amount of credit available in times of crisis by expanding the use of SDRs and increasing the size of quota-linked funds. It should also facilitate the recycling of surplus funds from surplus to current account deficit countries using vehicles such as the oil facility. A new version of the CCL should be revived with more funding and less costs and conditionality than its predecessor.

C. RESPONDING TO EXOGENOUS SHOCKS¹⁴

56. We stress the need for multilateral financial institutions, in providing ... financial support... to pay due regard to the special needs and implementing capacities of developing countries and countries with economies in transition, aiming at economic growth and sustainable development.

59 ... (W)e underline the need to ensure that the international financial institutions, including the International Monetary Fund, have a suitable array of financial facilities and resources to respond in a timely and appropriate way in accordance with their policies.

Source: Monterrey Consensus Document.

Low-income countries suffer from multiple, frequent and severe shocks, ranging from instability of aid and trade flows, to natural and climatic disasters. At the same time planning and management of these shocks is poor, with the international financial institutions persistently under-estimating their risks and impact. Shocks impact negatively on GDP and evidence now suggests that they hit the poor the hardest thereby provoking a major set-back for progress towards the Millennium Development Goals (MDGs). Furthermore, economic shocks undermine debt sustainability in a number of indebted low-income countries, as well as threatening countries' fiscal position.

The international community has been ineffective in protecting against shocks and/or cushioning the impact. Insufficient attention has been given to avoiding the occurrence of such shocks through better forecasting and policies as well as counteracting them rapidly with financing that is cheap, flexibly, sufficient, and free of excessive conditionality.

Private sector solutions such as self- or regional country insurance mechanisms could complement an anti-shocks facility. However, this solution would be useful only for single shocks, not for multiple shocks across time and locations. In addition, the price and technical capacity needed to use many of these mechanisms reduce their utility for low-income countries. Commodity price agreements or stabilization tools could be useful tools but only for some types of shocks.

An effective anti-shock facility should be created through the provision of extra financing. In designing this facility it is unavoidable to examine the adjustment vs. financing balance. In this

¹⁴ Matthew Martin and Hannah Bargawi, "Protecting Africa Against "Shocks,'" Debt Relief International, September 2004. Available at www.new-rules.org

context, it would be important to limit the adjustment element, so as to ensure that financing decisions are driven by the needs of the country affected by the shocks, and not by the political agenda of various donors.

New Rules recommends:

13. Establish a fast-responding, overarching, grant-financed shocks facility for low-income commodity dependent countries. It could be administered by a Bretton Woods Institution.

V. GOVERNANCE

A. GOVERNANCE OF THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND¹⁵

An overarching concern of these consultations was the need to ensure broad political and strategic guidance at the international level that is essential to the implementation of the complex development agenda. The need for mechanisms alongside the lines of the Secretary General's proposal¹⁶ for establishing an Executive Committee of ECOSOC at the intergovernmental level was underscored. The following recommendations address more specific and complementary proposals that would implement the Monterrey Consensus mandate to reform the governance of: a) the Bretton Woods Institutions, and b) other financial agenda and standard-setting bodies.

61. Good governance at all levels is also essential for sustained economic growth, poverty eradication and sustainable development worldwide. To better reflect the growth of interdependence and enhance legitimacy, economic governance needs to develop in two areas: broadening the base for decision-making on issues of development concern and filling organizational gaps.

62. We stress the need to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting.

63. A first priority is to find pragmatic and innovative ways to further enhance the effective participation of developing countries and countries with economies in transition in their international dialogues and decision-making processes. ...we encourage the following actions:

- International Monetary Fund and World Bank: to continue to enhance participation of all developing countries and countries with economies in transition in their decision-making, and thereby to strengthen the international dialogue and the work of those institutions as they address the development needs and concerns of these countries. ...*
- Ad hoc groupings that make policy recommendations with global implications: to continue to improve their outreach to non-member countries, and to enhance collaboration with the multilateral institutions with clearly defined and broad-based intergovernmental mandates.*

53. Important international efforts are under way to reform the international financial architecture. Those efforts need to be sustained with greater transparency and the effective participation of developing countries and countries with economies in transition.

Source: Monterrey Consensus Document.

The current Boards of the World Bank and International Monetary Fund¹⁷ continue to reflect the economic weights of the world of 1944, with 60% of the votes allocated to the industrialized

¹⁵ Murilo Protugal, "Improving IMF Governance and Increasing the Influence of Developing Countries in IMF Decision-Making," G24 Technical Group Meeting, March 2005, and Vijay L. Kelkar, Praveen K. Chaudhry, Marta Vanduzer-Snow, and V. Bhaskar, "The International Monetary Fund: Integration and Democratization in the 21st Century," G24 Technical Group Meeting, March 2005. Available at www.g24.org

¹⁶ UN Secretary General, "In larger freedom: towards development, security and human rights for all." Integrated and coordinated implementation of and follow-up to the outcomes of the major United Nations conferences and summits in the economic, social and related fields. Follow-up to the outcome of the Millennium Summit. A/59/2005, 21 March 2005.

¹⁷ Discussion will focus on the IMF since the allocation of votes and seats on the World Bank depends in large part on IMF quota allocation.

countries and 40% to the rest of the world. Today, these allocations do not conform to the size of economies or of population. Indeed the very formula for allocation is unscientific and biased toward the existing largest vote holders.

Three elements should be included in any future quota formula: 1) Measurement of economies by Purchasing Power Parity (PPP), instead of the current approach which translates the national GDP into market-based exchange rates, thereby unfairly underestimating the size of developing country economies. 2) Measurement of a country's need for IMF support, which could be captured by the variability of the current account, external debt, volatility of capital flows and general economic vulnerability indexes. 3) Countries belonging to a currency union such as the Euro Currency Union are not subject to internal balance of payments crises. Hence, intra-currency union trade should be excluded from the quota formula. Discontinuing the current practice would reduce the size of the Euro-currency zone countries' quotas, which are currently over-represented. The quota formula can be revised without an amendment to the Articles of Agreement. However, any quota increase—the only vehicle for adjusting quota sizes—must be approved by 85% of the vote (the US holds over 17%; the EU combined accounts for over 30%).

The Bretton Woods Conference recognized the legal equality of all member states by allocating 250 basic votes to each member. Initially basic votes represented 11.3% of the total; today they are 2.3%. The main beneficiaries of bringing basic votes back to 11.3% of the total will be the African countries. The Articles must be amended to achieve this change.

Double majorities can be shaped so as to increase the participation of developing countries in decision-making. For instance, certain decisions could be subject to a majority of the total weighted vote of member countries plus the numerical majority of all developing countries. This tool could be used immediately on a pilot basis subject to evaluation, while paving the way for their introduction via reform to the Articles of Agreement in the longer

Currently the number of chairs occupied by European members symbolizes the skewed distribution of power on the Boards. Of the 24 seats, European countries occupy either 8 or 9 when Spain holds the seat of the constituency it shares with Mexico, Venezuela, Bolivia and five Central American countries. Two African EDs represent 42 countries, all of whom have programs or loans. Mixed constituencies (representing developed and developing countries) are represented by the industrial country member, and cannot split their votes nor note dissenting views among the members. The Euro-currency countries should share a single chair reflecting their single currency. Seats vacated by reduced representation of European countries could be allocated to middle-income countries receiving additional votes and to the Sub-Saharan African countries, who should gain two additional chairs based purely on their workload.

While normative judgments may drive recommendations in a clear direction, political challenges abound. Status quo powers argue that the current system works well, since votes are rarely taken. Borrowers are concerned about antagonizing donors, and possibly the market. Pessimists question whether any changes in policies or outcomes would happen given the monolithic economic discipline. Optimists share the perspective of those acting on normative criteria: new voting structures (and leadership selection mechanisms) could result in new power dynamics and new alliances; allow space for more diverse policy views; and greater diversity among senior

staff selection. Restoring the credibility and effectiveness of the institutions should be based on a normative approach.

New Rules recommends:

14. To restore their effectiveness and credibility, the governance structure of the World Bank and IMF must conform more closely to democratic principles. The IMF Executive Board should:

- **Expand and reallocate quota-based votes using a new formula that: a) measures the size of economies by purchasing power parity (PPP); and b) a measure of vulnerability, and hence of potential need for Fund resources.**
- **Reallocate basic votes to the percentage effective at its creation (back to 11.3%, from the current 2.3%)**
- **The leadership selection for the World Bank and IMF must be based on clear and democratic processes and criteria, as identified in the Report by the Joint Working Group of Fund and Bank Executive Directors, endorsed by the Executive Boards in April, 2001.**
- **The use of double majorities that require a majority of developing countries in order to adopt certain decisions should be introduced.**
In the interim, the chairs of the respective Boards, the President in the case of the World Bank and the Managing Director in the case of the Fund, should refrain from taking a decision when the Board is split between “number of votes” and “number of Executive Directors” or “number of countries.” The chair should instead work toward a genuine consensus where policy matters are concerned.
- **Board decisions must be open, including the content of the debate and the positions taken by each Executive Director.**
- **The actions of the institutions and of the relevant Executive Directors should be open to scrutiny by national Parliaments, public media, and civil society.**
- **An interim arrangement should allocate two additional Executive Directors for Sub-Saharan Africa.**

B. GOVERNANCE OF FINANCIAL AGENDA AND STANDARD-SETTING BODIES¹⁸

57. It is essential to ensure the effective and equitable participation of developing countries in the formulation of financial standards and codes

63. ...Bank for International Settlements, Basel Committees and Financial Stability Forum: to continue enhancing their outreach and consultation efforts with developing countries and countries with economies in transition at the regional level, and to review their membership, as appropriate, to allow for adequate participation;

Source: Monterrey Consensus Document.

¹⁸Stephany Griffith-Jones and Jenny Kimmis, “The Reform of Global Financial Governance Arrangements,” Institute of Development Studies, University of Sussex. Report prepared for the Commonwealth Secretariat, 2001. Available at www.new-rules.org

More than sixty standards and codes have been developed by bodies of a public, private or private-public nature. The Financial Stability Forum (FSF), a body established by the Group of Seven in 1999 in response to the Asian financial crises, has identified 12 of those standards as essential to achieving financial stability. Subsequently, those standards have become the basis for Financial Sector Assessment Programs (FSAPs) and Reports on Standards and Codes (ROSCs) carried out by the World Bank and the IMF. These programs are the basis for the surveillance, conditionality, technical assistance and policy dialogue with member countries regarding their financial sector reforms. The Bank and Fund exercise far greater leverage over their borrowing country members than over the industrialized countries, making the implementation process highly asymmetrical.

These standards have been designed by bodies with limited or no access or membership from developing countries. For instance, the Basle Committees are committees of the Group of 10, representing the Central Banks of 10 large economies. While the Basle Committee on Global Financial System regularly invites some emerging market countries to its meetings, participation cannot happen without an invitation. The Basle Committee on Banking Supervision has no participation from developing countries, though they have separate consultations. The International Accounting Standards Board comprises 14 members, 3 from continental Europe and the remaining from the US and the UK. The Financial Stability Forum also performs broader functions relating to global financial stability, but has only four member countries apart from the G-7 countries. The FSF also has representatives from the World Bank, IMF, Organization for Economic Cooperation and Development (OECD), the International Association of Insurance Supervisors (IAIS), the European Central Bank, the 3 above-mentioned Basle Committees, and the International Organization of Securities Commissioners (IOSCO). While developing countries have occasionally been involved in some ad hoc working groups of the FSF, participation only happens by invitation.

Many of these bodies, in spite of their limited membership, do engage in extensive consultations with developing countries. However, consultation and outreach do not substitute for effective and formal representation. Limited membership is sometimes justifiable on an efficiency basis. However, mechanisms (such as rotation and reporting back) could guarantee more representativity without large increases in membership. If greater participation by developing countries were to serve as a drag on achieving consensus on standards, and threaten to reduce standards to the lowest common denominator, then a two-track process could be established. This would recognize that standards needed today in highly capitalized economies are not necessarily a priority in lesser developed economies. Only participation by smaller and less developed economies ensure that potential harmful effects of such standards on their economies are taken into consideration. Some of the current limitations of the Basle Capital Accord II seem to reflect the lack of participation of developing countries in the Committee.¹⁹

New Rules recommends:

15. Financial agenda and standard-setting bodies, beginning with, the Financial Stability Forum, the Basle Committee for Banking Supervisions and Basle Committee on the Global Financial System, and the Bank for International Settlements, should include developing

¹⁹ See discussion above under II. A. “Prudential Regulation of Financial Markets.”

countries in their membership and deliberations, through the adoption of principles of representation and rotation.

16. All interested countries should be invited to participate in current and future working groups of these entities.

17. A committee should be established as soon as possible (with participation of the standard-setting bodies as well as of developing countries) for implementing and evaluating specific proposals to achieve these recommendations (#15 and #16).

18. Decisions regarding design, endorsement and implementation of financial standards and codes at the Bretton Woods Institutions should be subject to double-majority rules.

VI. FINAL RECOMMENDATIONS²⁰

1. Designing and implementing prudential regulations for financial markets and financial institutions in order to enhance transparency, govern risk taking and foster orderly marketplaces. This should reduce the build up of exposures to risks in such areas as foreign exchange, maturity mismatch, liquidity, and concentrated credit exposures. Especially important is the application of prudential regulation to derivatives markets, which are growing rapidly in the developing world.
2. Use prudential regulation and capital controls in order to facilitate the use of counter-cyclical monetary and fiscal policy by developing country governments.
3. In order to prevent buildup of foreign exchange rate risk and to encourage improvements in local financial markets, promote international lending in local currencies and promote international investing through the use of diversified portfolios of local currency assets.
4. Promoting better commodity price risk management by supporting government efforts to hedge the correlation between budget revenues and commodity price fluctuations and providing simple and affordable risk management to small, local producers.
5. Governments should implement and intensify the exchange of information in tax matters between governments (particularly the automatic exchange of information), overriding bank secrecy and other confidentiality laws in tax matters.
6. OECD countries should comply with the same rules and standards that the OECD requires of non-OECD jurisdictions regarded by the OECD as tax havens.
7. Developing country jurisdictions that currently rely on bank secrecy and tax free treatment for revenue should be assisted to shift to other revenue producing activities for development.
8. Governments should use, in an appropriate mix, policy instruments to ensure the availability of long-term credit, on affordable terms, to support the productive economy.
9. Establishing domestic and public development finance institutions should be encouraged and supported by international financial institutions, donors, and when feasible, the private sector, including through the provision of technical assistance and equity investment.
10. Micro-finance institutions need and deserve a prudential regulatory framework that suits their special characteristics and that protects the public interest from financial instability, fraud, and predatory lending.
11. Pursuing the development of a new mechanism, the International Debt Framework (IDF), to improve crisis prevention and resolution in the international financial system. The mechanism

²⁰ Not all members of the New Rules for Global Finance Coalition agree with every aspect of every recommendation. We operate in a mode of tolerance for differences and respect for one another's expertise.

could be initiated by the Group of 20 Finance Ministers from developed and developing countries. After its establishment, the IDF should not be limited to G20 member states.

12. The IMF should increase the amount of credit available in times of crisis by expanding the use of SDRs and increasing the size of quota-linked funds. It should also facilitate the recycling of surplus funds from surplus to current account deficit countries using vehicles such as the oil facility. A new version of the CCL should be revived with more funding and less costs and conditionality than its predecessor.

13. Establish a fast-responding, overarching, grant-financed shocks facility for low-income commodity dependent countries. It could be administered by a Bretton Woods Institution.

14. To restore their effectiveness and credibility, the governance structure of the World Bank and IMF must conform more closely to democratic principles. The IMF Executive Board should:

- Expand and reallocate quota-based votes using a new formula that: a) measures the size of economies by purchasing power parity (PPP); and b) a measure of vulnerability, and hence of potential need for Fund resources.
- Reallocate basic votes to the percentage effective at its creation (back to 11.3%, from the current 2.3%)
- The leadership selection for the World Bank and IMF must be based on clear and democratic processes and criteria, as identified in the Report by the Joint Working Group of Fund and Bank Executive Directors, endorsed by the Executive Boards in April, 2001.
- The use of double majorities that require a majority of developing countries in order to adopt certain decisions should be introduced.

In the interim, the chairs of the respective Boards, the President in the case of the World Bank and the Managing Director in the case of the Fund, should refrain from taking a decision when the Board is split between “number of votes” and “number of Executive Directors” or “number of countries.” The chair should instead work toward a genuine consensus where policy matters are concerned.

- Board decisions must be open, including the content of the debate and the positions taken by each Executive Director.
- The actions of the institutions and of the relevant Executive Directors should be open to scrutiny by national Parliaments, public media, and civil society.
- An interim arrangement should allocate two additional Executive Directors for Sub-Saharan Africa.

15. Financial agenda and standard-setting bodies, beginning with, the Financial Stability Forum, the Basle Committee for Banking Supervisions and Basle Committee on the Global Financial System, and the Bank for International Settlements, should include developing countries in their membership and deliberations, through the adoption of principles of representation and rotation.

16. All interested countries should be invited to participate in current and future working groups of these entities.

17. A committee should be established as soon as possible (with participation of the standard-setting bodies as well as of developing countries) for implementing and evaluating specific proposals to achieve these recommendations (#15 and #16).

18. Decisions regarding design, endorsement and implementation of financial standards and codes at the Bretton Woods Institutions should be subject to double-majority rules.