IMPROVING GLOBAL FINANCIAL COHESION

THE IMPORTANCE OF A COHERENT INTERNATIONAL ECONOMIC AND FINANCIAL ARCHITECTURE

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Foreword

On 27 August 2013, the Advisory Council on International Affairs (AIV) was asked to produce an advisory report on the coherence of the international economic and financial architecture (see Annexe I). The request centred on the position of the 'smaller emerging economies and poorer countries', the assumption being that the changing balance of power around the world means that there are insufficient guarantees that their interests will be protected. Is the limited influence of this group of countries in the international system indeed inevitable, or is there scope for achieving better results?

The request for advice posed the following three core questions:

- Are the smaller emerging economies and poorer countries adequately represented?
- What are the specific interests of this group?
- How should Dutch coherence policy engage with the issues raised?

The report seeks to contribute to the development of a coherent Dutch strategy for the international economic and financial architecture and development cooperation. The report was compiled by a combined AIV committee chaired by Professor R.E. van der Hoeven (Development Cooperation Committee). The other members of the committee were: F.A.J. Baneke (Development Cooperation Committee), Dr B.S.M. Berendsen (Development Cooperation Committee), Ms H.C.J. van den Burg (Human Rights Committee), J. van Ham (Development Cooperation Committee), Professor C.W.A.M. van Paridon (European Integration Committee), Professor M.E.H. van Reisen (AIV, Development Cooperation Committee) and Ms M.C.B. Visser (European Integration Committee). The executive secretary was P. de Keizer, assisted by two trainees, Ms J. van Laar and Ms E.A.M. Meijers. Additional assistance was provided by Ms N.P.F. Bollen and F.C. Haver Droeze, the civil-service liaison officers at the Ministry of Foreign Affairs.

In preparing the report, the committee performed desk research, interviewed experts from private-sector firms, civil-society organisations, the Dutch central bank (De Nederlandsche Bank, DNB), the Ministry of Finance, universities, international organisations and research institutes, as well as former Dutch directors of international financial institutions. A large number of experts attended a meeting held in London in January 2014 under the auspices of the Overseas Development Institute (see Annexe III).

The AIV discussed the report at its meeting on 6 June 2014 and adopted it on 25 June 2014.

I Introduction

'We need to change the way business is conducted in international financial institutions. They need to be reformed.' These were the words of the South African Minister of Foreign Affairs, Ms Maite Nkoana-Mashabane, at a summit meeting in Johannesburg on 5 March 2013.[1] Shortly after this meeting, Brazil, Russia, India, China and South Africa announced their intention of setting up a development bank and stability fund of their own. The larger emerging economies felt that their interests were not adequately served by the current international institutions. The pressure to change the system is mounting.[2]

The global financial crisis of 2008 again exposed the system's weaknesses. Although certain changes have been made in the intervening period, these have been primarily in the nature of crisis management. Much less action has been taken to deal with the consequences of the turbulent growth in the financial markets during the decades prior to the crisis. In essence, the system continues to be based on agreements reached in Bretton Woods in 1944.

It is high time to make further reforms to the system, particularly in the light of the way in which poorer countries are represented, their access to the system and products such as loans, and the influence they have over the decision-making process. This underlines the need, for Netherlands just as much as for other countries, to keep a close eye on the agenda for the international economic and financial system in the coming years and, where possible, to inject fresh momentum into it.

The AIV expects this agenda to come under stronger pressure in the years ahead. For this reason, this report contains a series of recommendations for necessary changes to the system and to the status of poor countries in the system. At the same time, the AIV believes that even the current configuration of the economic and financial system offers opportunities for improving the economic development and macroeconomic stability of poor countries. This is why the recommendations made in this report fall into two categories: recommendations for fundamental reforms on the one hand, and recommendations that can largely be implemented in the current structure on the other.

Chapter II outlines the background and composition of the international economic and financial system. The system has gradually evolved from one intended for governments into one based on contributions from – and relevant to – a larger group of actors. We have seen strong growth in the size of private financial institutions and capital flows, in both absolute and relative terms. Since the outbreak of the financial crisis, there has been an increasing tendency to combine self-regulation by market players with far-reaching forms of national and international regulation. At the same time,

1 M. Cohen and I. Arkhipov, 'BRICS Nations Plan New Bank to Bypass World Bank, IMF', Bloomberg, 26 May 2013. See: <http://www.bloomberg.com/news/2013-03-25/brics-nations-plan-new-bank-to-bypass-world-bank-imf.html>.

2 N. Stern, A. Bhattacharya, M. Romani and J.E. Stiglitz, 'A New World's New Development Bank', Project Syndicate, 1 May 2013. See: <http://www.project-syndicate.org/commentary/the-benefits-of-the-brics-development-bank>.

actors have become less willing to subject themselves to supranational rules and agreements, as enshrined in the articles of agreement of the Bretton Woods institutions. Intergovernmental talks are the name of the game these days. Political power plays a major role.

Chapter III examines the forces currently influencing the international financial system. They include the emergence of the BRICS economies (i.e. Brazil, Russia, India, China and South Africa), which is engendering geopolitical shifts, putting extra pressure on the system, and further globalising and accelerating innovation in the financial markets. The challenges are not only of a financial, economic and technical nature, but are also social, such as growing income and wealth disparity and persistent gender inequality within countries.

The size and role of foreign capital in low-income countries forms the subject of chapter IV. Capital flows have grown more volatile in recent years, particularly after the 2008 crisis, resulting in major fluctuations in incoming foreign capital. Against this background, the AIV seeks to ascertain how developing countries can protect themselves against a glut of short-term capital, which may in turn again trigger macroeconomic instability and lower or imbalanced economic growth. The role of foreign capital is examined in relation to other financial flows, such as ODA (official development assistance) and remittances, and also in relation to capital flight and tax regimes that lead to tax evasion or tax avoidance.

Chapter V looks at how low-income countries can benefit more from the current system and build up their resilience to its potential adverse effects. It examines the impact of cross-border capital movements on these countries' economic growth and debt positions. Given the important role played by their domestic financial sectors, it discusses the possible ways in which their development can be fostered – or is hampered – by the liberalisation of the capital market and the supervisory rules for the international system. This chapter also describes how the conditionality imposed by international financial institutions affects countries' domestic economic and financial policies. Finally, it stresses the importance of formulating a step-by-step plan for the development of local financial sectors.

The importance of coherence and global governance in relation to the international economic and financial system is explained in chapter VI. The AIV recommends a variety of global governance measures that can boost the development potential of poorer countries. These include systemic changes which can allow private capital to have a more powerful positive effect on low-income countries, help low-income countries to have more say in decision-making processes that have a bearing on them, and provide better means of coping with external shocks. The AIV also makes a number of recommendations for improving the overall efficiency of the system of global governance. Low-income countries should be able to benefit from such improvements. The recommendations made in this connection concern the need to reflect on the relationship between the operation of the G20 and the rest of the international economic and financial system, the role played by a modernising International Monetary Fund (IMF), changes in the loan system and the relationship between the IMF and the regional financial arrangements proposed by the BRICS countries, and the need to devise more coherent debt-relief mechanisms.

Chapter VII concludes that the impact of the international economic and financial system on low-income countries tends to rise in line with the latters' degree of integration into

the global economy. Although integration helps to attract capital, it does create certain risks to a country's stability. An international system that offers greater stability is also important for low-income countries. However, growing frictions are emerging in the financial sector. Despite the action taken by many governments, such as compulsory takeovers of failing or failed banks, tighter regulation and bank supervision, public calls by politicians for pay restraint and legislation on bonuses, public confidence in the financial sector has yet to be restored. Public confidence has to be restored in order to broaden support for the necessary changes in the international economic and financial system. This chapter sets out the AIV's recommendations for measures that could be taken within the existing system (or after minor changes have been made to it) to improve the position of low-income countries. The AIV also recommends measures for changes in the system that will probably take longer to realise, but on which the Dutch government already needs to take a position, given the pressure on the system.

II The international economic and financial system and its architecture

The international economic and financial system is the panoply of bodies and regulations determining the financial relationships between countries.[3] Much of the system is explicitly regulated and anchored in institutions, often referred to as the 'architecture'. The principal aim of the system is to prevent, and where necessary defuse, tensions in and between member countries. Four instruments are used for this purpose:

1. adjusting domestic balance sheets and balances of payments in order to restore equilibrium;
2. granting (foreign-currency) loans to avoid the need for damaging emergency measures;
3. preventing closely related institutions and markets from having an adverse effect on macroeconomic stability ('macro-prudential measures');
4. promoting the movement of capital between countries.

The relative use made of these four instruments depends on the design ('architecture') of the system.

Although it could be argued that the international system only concerns relations between countries and their national systems, it seems more accurate to adopt a more dynamic interpretation in which the international system is seen as the product of the underlying national systems. This is because its operation depends to a large extent on the behaviour of a number of national systems and the policies pursued in this connection, especially in the United States.

The Bretton Woods system, with its fixed but adjustable exchange-rate parities and its gold-dollar standard, was adopted after the Second World War. The system includes two important institutions, the IMF and the International Bank for Reconstruction and Development (the 'World Bank'). These are specialised United Nations (UN) agencies that are independent and have their own members and tasks. Both institutions have signed treaties with the UN regulating the relationship between them. The treaties grant both the IMF and the World Bank a certain measure of freedom to act independently of the UN.[4]

3 See Annexe IV, especially sections 1 to 6, for further background information.

4 The treaties state that the IMF and the World Bank are independent international organisations, i.e. that they are not dependent on and subordinate to the UN. However, this independence is somewhat restricted by article VI (1) of the treaties, which reads: *The Fund takes note of the obligation assumed, under paragraph 2 of Article 48 of the United Nations Charter, by such of its members as are also Members of the United Nations, to carry out the decisions of the Security Council through their action in the appropriate specialized agencies of which they are members, and will, in the conduct of its activities, have due regard for decisions of the Security Council under Articles 41 and 42 of the United Nations Charter*. The activities of the UN and its specialised agencies are coordinated, organisationally speaking, by the UN System Chief Executives Board for Coordination. This board, which is chaired by the UN Secretary-General, is composed of the highest-ranking executives of the organisations that form part of the UN system. Policies are coordinated by the Economic and Social Council (ECOSOC), in accordance with article 63 of the United Nations Charter.

The IMF's mandate is to monitor the exchange-rate system and to grant loans to the member states so that they can maintain a healthy balance of payments. Member states' voting rights are proportionate to their financial contributions. The arrangements made in this respect reflect the balance of geopolitical power immediately after the Second World War. Big member states such as the US have their own seat on the board, while small countries work together in 'constituencies'.

The World Bank was given the job of assisting the reconstruction of the war-torn economies. Later on, a new objective was added, i.e. fostering the development of underdeveloped countries. Its management structure is largely the same as that of the IMF, the main difference being that it is based on percentage shares of its equity capital. In 1960, the World Bank set up a subsidiary for making concessional loans to relatively poor developing countries. Known as the International Development Association (IDA), this organisation is funded by donations. The World Bank also has a branch called the International Finance Corporation (IFC), which makes direct loans to foster private-sector development in developing counties. Another important organisation is the Multilateral Investment Guarantee Agency (MIGA), which was founded in 1988 and whose mission is to promote private investment in developing countries by issuing guarantees against political risks.[5]

The IMF introduced an artificial reserve currency known as the Special Drawing Right (SDR) at the end of the 1960s. It was designed to take the pressure off the US dollar and in fact to replace the dollar in the long term. Little has come of this, however. As is made clear later on in this report, the AIV is very much in favour of making much more use of SDRs.

In 1973, the system of a fixed gold-dollar rate and fixed but adjustable parities had to be abandoned. With capital flows difficult to keep under control, variable exchange rates were inevitable. Systematic reserve formation was no longer seen as one of the system's priorities. In the 1990s, countries began to build up their own reserves so as to become less dependent on the IMF. The resultant imbalances are regarded as one of the causes of the financial crisis in 2008.

Although the IMF and the World Bank have always tried to steer clear of politically sensitive issues of national wealth distribution, this situation is set to change. It is interesting to note, for example, that both the World Bank and the IMF's Research Department are now studying the relationship between inequality and economic growth and efficiency, given that studies have shown that extreme inequality undermines economic growth.

Impact on low-income countries

During the 1980s, many poor countries began to find it impossible to pay off their debts without seriously harming their development potential. This prompted a number of adjustments to the architecture. Fears about the bad example that might be set by debt forgiveness (known as 'moral hazard') were allayed by the creation of a special strategy for 'heavily indebted poor countries' (HIPCs). This was based on the IMF's and

5 Between 1990 and 2011, the MIGA issued 650 insurance guarantees for investments worth USD 25 billion in over 100 developing countries (mainly in Eastern Europe and sub-Saharan Africa). The instrument is certainly not free of criticism: international companies have allegedly misused it to bring claims against certain governments.

World Bank's calculation of what was a sustainable level of debt, in conjunction with a treaty amendment to be agreed with the IMF. The Paris Club played a major role in the development of this strategy.[6]

Sub-Saharan African countries have two seats on the boards of both the IMF and the World Bank. Each seat represents 21 countries, the bulk of which are low-income countries (i.e. 28 out of the total of 42). The remaining eight non-African low-income countries are united in other constituencies. For some time now, complaints have been made about the lack of representativeness in the way seats are distributed, with many strong objections being levelled at Europe's relative over-representation. Although certain changes in the system of IMF quotas were proposed in 2010, a decision on the proposal has been deferred pending the approval of the US Senate. The informal political arrangement between the US and Europe on the distribution of top jobs at both institutions is another source of discontent.

A meeting held in Istanbul in 2011 under the auspices of the UN's Economic and Social Council led to calls for a critical review of the international financial architecture. The final declaration stressed that 'voice' should be a guiding principle: '*The international economic system and architecture should be inclusive and responsive to the special development needs of least developed countries, ensuring their effective participation, voice and representation at all levels*.'[7] A previous meeting had already concluded that, as part of a broader framework of international law, the international financial institutions should set great store by respect for human rights.[8]

Partly as a result of the global financial crisis in 2008, there has been a rise in the number of loan commitments in relation to low-income countries. The IMF reduced the size of interest payments and also created three new, flexible lending facilities to address countries' needs for short-term and emergency support, to provide conditionality for structural reforms and to boost 'pro-poor' expenditure. Although the World Bank did not actually adjust its policy on low-income countries, the IDA is designed to meet the long-term needs of such countries.

6 The Paris Club is an informal group of senior Treasury officials chaired by the Director-General of the French Ministry of Finance. The group first began meeting in the wake of the Argentinian crisis in 1956. The international financial institutions, UNCTAD, the OECD and the regional development banks have observer status. Many commentators believe that the worldwide Jubilee Debt Campaign for debt relief helped to pave the way for a deal on the HIPCs.

7 Fourth United Nations Conference on the Least Developed Countries, (2011) 'Istanbul Declaration', Istanbul, 9-13 May 2011; and 'Programme of Action for the Least Developed Countries for the Decade 2011-2020', Istanbul, 9-13 May 2011.

8 'Trade, finance and investment are in no way exempt from human rights obligations and principles (…) international organizations with specific responsibilities in these areas should play a positive and constructive role in relation to human rights.' (Sub-Commission resolution 1998/12, United Nations, Economic and Social Council, Sub-Commission on Prevention of Discrimination and Protection of Minorities, Human rights as the primary objective of trade, investment and financial policy, UN Doc. E/CN.4/Sub.2/Res/1998/12, 20 August 1998.)

Other bodies
The Basel Committee on Banking Supervision was set up in 1974 in the wake of a number of bank collapses. The Committee is intended to function as a platform for discussing standards and guidelines for banking industry supervision. Its pronouncements and recommendations are not legally binding. Membership was originally restricted to the G10, but has now been extended to 27 countries, each of which is represented by its national banking regulator, generally the central bank. The first Basel Capital Accord, setting out minimum capital requirements for banks, was published in 1988. These rules have since been adjusted, first in 1999 and subsequently in 2004.

Even then, concerns were expressed about the problems caused by excessive leverage, insufficient liquidity, inadequate governance and risk management, and perverse incentive pay structures (bonuses in particular). Taken together, these factors led to the mispricing of credit and liquidity and to excessive lending. However, it was not until 2010 that a stricter package of rules was adopted, this time by the G20.[9] So many rules and regulations have now accumulated, however, that they are hard to enforce in practice. This applies particularly to low-income countries, which were scarcely involved (if at all) in their formulation.

Although, when it was founded, the IMF was assigned a supranational role – as a supervisory authority, for example, or in making adjustments for exchange-rate manipulation – its authority has slowly but surely been eroded over the years. Its supranational role has been superseded by intergovernmental consultation, talks outside the institution itself and embracing just a select group of countries, beginning with the G5 in the 1970s and passing through the G7 and G8 to end with the G20 in 1999. The G20 played a prominent role during the worldwide crisis in 2008, which was also when the Financial Stability Forum was relaunched as the Financial Stability Board (FSB). The political pressure slowly receded during the years after the crisis and member states' interests began to diverge more and more. Nevertheless, as an intergovernmental consultative body, the G20 continues to leave a firm stamp on the operation of international financial institutions such as the IMF and the World Bank.

One of the products of these intergovernmental meetings was the establishment of the Financial Action Task Force (FATF) in 1989, during a G7 summit. The FATF has its seat in Paris, where it is based in the OECD's offices. Its job is to combat money-laundering by drafting legislation and devising suitable counter-measures, and by encouraging both members and non-members to adopt them. Following the events of 9/11, its remit was extended to include anti-terrorism. Its members come from the OECD, the European Commission and the Gulf Cooperation Council, as well as Argentina, Brazil, Russia, Singapore, Hong Kong and China. There are also a number of regional associations of non-members, including three in Africa. For a number of years, the FATF operated a blacklist of jurisdictions regarded as not being sufficiently cooperative. The blacklist had a powerful effect as a form of peer group pressure. Decisions are taken by consensus and have led in practice to the adoption of national legislation by the member states and

9 The new agreement, known as the Basel III Accord, reinforces the three pillars of the Basel II Accord and also adds a number of new elements, for example in relation to big banks, which are regarded as posing a systemic risk. A fundamentally new aspect, i.e. macroeconomic considerations, was added to banking supervision, which is now no longer concerned solely with the health of individual banks, but also explicitly addresses the state of the financial system as a whole. Despite the incorporation of these new elements, provision has not been made for aspects such as the risks pertaining to cross-border capital flows.

the EU (in the case of the Netherlands, the Money Laundering and Terrorist Financing (Prevention) Act 2008). The FATF has benefited those low-income countries that are more closely integrated into the world economy. Its stamp of approval can help to gain the trust of lenders.

The Financial Stability Forum was set up in 1999. As already mentioned, it was relaunched as the FSB after the financial crisis. Membership is restricted to the same select group of countries which were previously members of the Financial Stability Forum, plus a small number of new members (including a couple of multilateral organisations). The relations between the members reflect their economic importance. For example, although the Netherlands has a seat on the FSB, South Africa is the only African country represented on the board. A number of regional consultative subgroups have now been formed, including one for sub-Saharan Africa. However, the input by these subgroups does not have any binding impact on FSB decisions.

The following institutions are also important on account of the economic clout represented by Europe and the eurozone: the European Banking Authority, the European Securities and Markets Authority (whose duties include keeping an eye on credit-rating agencies), the European Insurance and Occupational Pensions Authority, and the European Central Bank.[10] With a view to promoting financial stability and restoring public confidence in the financial system, the EU introduced a new supervisory system in January 2011. This is known as the European Financial Stability Facility (EFSF).[11] The banking union is intended to further consolidate banking supervision. Under this single supervisory mechanism, responsibility for the micro-prudential supervision of the systemic banks in the eurozone is to be transferred in 2014 from the national regulators to the European Central Bank. The EU is also preparing a European Deposit Guarantee Scheme to protect savings deposits, and a European Resolution Mechanism for dealing with troubled banks.

The international financial system also comprises regional financial institutions in the South. Africa, Asia and Latin America all have their own development banks in which regional members hold the majority of voting rights and which are modelled broadly on the World Bank.

Regional Financing Arrangements (RFAs) have been gaining in importance of late. These are arrangements made by groups of countries in the same region, with the aim of assisting each other and reducing their dependence on the IMF, which is viewed as being dominated by the West. Although these RFAs are still fairly limited in scope, they are proving increasingly popular as the facilities come with less conditionality and can generate a larger volume of swaps with neighbouring countries and trading partners.

10 See also ‘Towards Enhanced Economic and Financial Governance in the EU’, AIV advisory letter no. 19, The Hague, February 2012.

11 The EFSF consists of the following bodies: the European Systemic Risk Board for macro-prudential supervision, and three sectoral regulators for micro-prudential supervision, i.e. the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Markets and Securities Authority. The work of the European Systemic Risk Board centres on the robustness of the financial system as a whole. The Board operates in conjunction with other bodies such as the IMF, the FSB and the Basel Committee on Banking Supervision.

One of the most sophisticated arrangements is the Chiang Mai Initiative for Multilateralisation (CMIM). It started in 2000 with the launch of a network of exchange-rate swap agreements among the ASEAN+3 economies, with the aim of reducing their dependency on the IMF's conditional facilities. This has proved hard to achieve in practice, however. To date, the member countries have been able to access no more than 30% of their agreed borrowing limits without IMF supervision. The initiative was extended in 2011 with the foundation of the Asean+3 Macroeconomic Research Office (AMRO), whose task is to provide the CMIM with analytical support and also act as an independent supervisor. In view of the IMF's vast experience and expertise, coupled with AMRO's relatively limited capacity, a form of collaboration between the IMF and AMRO has gradually come into being. In other words, the formation of the CMIM has not resulted in the CMIM countries drifting away from the IMF. Rather, it has led to a different type of partnership and a more regional form of global governance.

III Challenges facing the international economic and financial system

The shift in the balance of global economic power is putting pressure on the international economic and financial system. Representatives of emerging economies such as China, India and Brazil have been critical both of the way in which the international financial institutions work and of the attitude taken by the Western powers. For example, the Brazilian IMF representative strongly criticised the large loans that the IMF allowed Greece to raise when it found itself in difficulties as a result of its own mismanagement and the global financial crisis. The governor of the Indian central bank (a former Chief Economist at the IMF) also criticised US monetary policy, which, he claimed, was geared primarily towards protecting US interests rather than serving the interests of the international financial system as a whole. He argued that, after India and China had helped to create stability after the 2008 crisis by pursuing a tight fiscal policy, India itself was now being destabilised by the US administration's decision to end its policy of monetary easing.

The US dollar remains the leading currency in the world economy, with a large proportion of world trade and international investments being expressed and settled in dollars. Together with the euro, it underpins the bulk of global trade and investments. Almost 90% of the foreign deposits in central banks worldwide are held in dollar or euro accounts. The same is true of three quarters of foreign debt and two thirds of foreign-exchange trading.[12]

Another challenge is the global imbalances created, particularly during the past two decades, by trade surpluses and the accumulation of reserves, notably in Asia, as well as by the rising balance of payments deficits in the US and certain European countries. These imbalances are said to be one of the main causes of the financial crisis in 2008. The persistence of such surpluses and deficits over a period of many years has led to large cumulative debts and reserves, both of which are detrimental to balanced economic growth.[13]

Another issue that definitely needs to be addressed is the ever increasing 'financialisation' of the economy. This term refers to the growing size of the financial sector in relation to the real economy, and the fact that financial transactions and loans make up an ever bigger proportion of the gross national product (GNP). Studies have shown that, on average, the financial sector has grown twice as fast as the real economy

12 One of Charles de Gaulle's advisers once made the following comment about the leading role played by the US dollar: '*The functioning of the international monetary system is thus reduced to a childish game in which, after each round, the winners return their marbles to the losers*,' Jacques Rueff, as quoted by Alan Wheatley (2013) in *The Power of Currencies and Currencies of Power*, New York: Routledge, p. 24.

13 As expressed by Robert Zoellick, a former president of the World Bank: '*Changes in the global economy will likely require us to reconsider old intellectual strictures. Indeed, I suspect that the combination of structural shifts in the global economy and extraordinary monetary policies will push the topic of the future monetary system higher up the agenda*' (in: *The Power of Currencies*, December 2013, p. 137).

during the past 160 years.[14] There has been a particularly marked surge in growth in the past three decades: the value of loans compared with aggregate global GNP has doubled, and the value of bank deposits has tripled, since 1980. Certain banks now have balance sheet totals many times higher than the GNP of the country in which they are based.

'Financialisation' has both pros and cons. A larger amount of capital in circulation can foster economic growth. However, if more capital is brought into circulation than an economy can absorb in the form of productive investments, the surplus capital can fuel bubbles and boom-and-bust cycles characterised by wide fluctuations in asset values. This can have an adverse effect on lending and undermine confidence.

Linked to this is the rapid development of information technology, which enables markets to offer economic services on a large scale, such as deepening liquidity and channelling capital to productive destinations, at relatively low transaction costs. Physical trading on stock-exchange floors has been replaced by screen-based trading and extremely high-frequency trading ('hot money'). New, complex products based on sophisticated software algorithms are spreading risks more widely and interlinking markets ever more closely. Alongside new rules on the liberalisation of international capital flows and investors' need for diversification (for example, in the form of frontier funds investing in new, emerging economies), the result has been a sharp increase in international capital flows – with all the attendant consequences, such as higher volatility. Taken together, these various factors have helped to widen the gap between countries with access to advanced financial technologies and countries with less sophisticated financial sectors, barring exceptions such as Kenya, where mobile payment systems have become commonplace.

In many countries, globalisation and financial liberalisation have led to growing inequality, not just in terms of income disparities among households, but also in the ratio of labour to capital and in wealth.[15] Although income inequality is an ethical issue, it also has political and (as is increasingly being recognised) economic ramifications. Not only does it heighten domestic political tensions, it is also capable of undermining a country's macroeconomic stability, and hence affecting both the pace and the sustainability of economic growth.[16] Some commentators have even gone so far as to contend that inequality in the US was one of the causes of the global crisis in 2008.[17]

Inequality undermines confidence in national economic and financial systems, which is why it also eats away at the legitimacy of the international system. As Martin Wolff writes, '*In the past three decades we have seen the emergence of a globalised economic*

14 A. Haldane, speech at the Future of Finance conference: 'The contribution of the financial sector: Miracle or mirage?', London, 14 July 2010.

15 See, for example: International Labour Organization, *World of Work Report 2011: Income Inequalities in the Age of Financial Globalization* (2011), and: *Global Wage Report 2012/13: Wage and Equitable Growth* (2013), Geneva: International Institute for Labour Studies, and: *The Economist*, 9 January 2014.

16 International Monetary Fund (2014), 'Fiscal Policy and Income Inequality', IMF Policy Paper, January 2014.

17 Income inequality allegedly helped to increase the pressure on banks to lend to households. See: 'Fiscal Policy and Income Inequality', IMF Policy Paper, January 2014, p. 4.

and financial elite. Its members have become ever more detached from the countries that produced them. In the process, the glue that binds any democracy – the notion of citizenship – has weakened. The narrow distribution of the gains of economic growth greatly enhances this development. This, then, is ever more a plutocracy. A degree of plutocracy is inevitable in democracies built, as they must be, on market economies. But it is always a matter of degree. If the mass of the people view their economic elite as richly rewarded for mediocre performance and interested only in themselves yet expecting rescue when things go badly, the bonds snap. We may be just at the beginning of this long-term decay.'[18]

Linked to income inequality is gender inequality, which also has a big macroeconomic impact all over the world. The underutilisation of women's potential is tempering global economic growth. Of the 865 million women whose abilities are underused, 812 million live in emerging economies and developing countries. It is estimated that agricultural output in sub-Saharan Africa could rise by 10-15% if women were to receive the same technical and financial support as men.[19] Women in low-income countries have little influence on the macroeconomic policies pursued in these countries, where women hold just 20% (2013) of parliamentary seats. Rwanda is a notable exception, being the only developing country to have more female than male MPs (64% in 2013, 49% in 2005). Although the Gender Inequality Index[20] in many low-income countries has not actually deteriorated during the past 10 years, the global crisis may well have slowed down the narrowing of the gender gap.

Another challenge lies in the financing of global public goods, i.e. goods and services that in principle affect and/or should be available to everyone in the world. Climate change mitigation and education are good examples. With development and conventional aid taking increasingly divergent paths, it has become more difficult to arrange financing for these types of goods. Not only is official development assistance (ODA) used to finance expenditure for which it is not intended, certain development-related activities are funded from non-ODA resources.[21] What is needed is a clearer picture of the demand for the funding of global public goods and an indication of the demarcation line with conventional ODA. This is important with a view to formulating a new development strategy for post-2015. A pressing question is how the actors involved in the international system can respond to this challenge. The G20 drew up a development agenda in Seoul in 2010, identifying nine priority areas for action in the coming years.[22] Although the G20 members have drawn attention to these priority areas in various international forums, they have not yet served as guiding principles for the

18 M. Wolff, 'Failing Elites Threaten our Future', *Financial Times*, 14 January 2014.

19 R. Pearson, C. Sweetman (2011), *Gender and the economic crisis*, Rugby: Practical Action Publishing Ltd, in partnership with Oxfam GB.

20 UNDP database 2005-12, incorporating 24 of the 36 low-income countries.

21 See AIV advisory letter no. 25, 'Development Cooperation: Beyond a Definition', The Hague, May 2014.

22 Ranging from infrastructure, private investment and job creation, to human resources development, trade, financial inclusion, growth with resilience, food security, domestic resource mobilisation and knowledge sharing. See: 'Framework for Strong, Sustainable and Balanced Growth', G20 Seoul Summit Document, November 2010.

further design and development of the international financial system.

Illicit capital flows resulting from cross-border crime and corruption are a completely different matter. Massive sums of money are involved in these worldwide flows, which undermine the effective operation of the international financial system. The problem also affects developing countries, particularly those rich in natural resources (e.g. African countries such as Algeria, Libya, Nigeria, South Africa and Angola).[23] More and more treaties have been signed and organisations set up with the aim of curbing these illegal capital flows and forms of financial crime,[24] but, as the AIV pointed out in its report entitled 'Crime, Corruption and Instability: An Exploratory Report', such action can be effective only if countries allow their criminal justice systems to work together, and if the international financial system becomes more transparent.[25]

23 The United Nations Office on Drugs and Crime (UNODC) calculated that these capital flows represented 1.5% of the global GNP. It reckoned that around 70% of these flows are laundered and that no more than 1% is seized by the authorities. See UNODC, Estimating Illicit Financial Flows Resulting from Drug Trafficking and Other Transnational Organized Crimes, Vienna, 2011.

24 Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism of the Council of Europe, and the Vienna Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances. The treaty states are obliged to treat money laundering as a criminal offence. Although the FATF plays an important role in this connection, the UN Security Council is also involved as it is entitled to pass a binding resolution ordering the freezing of the financial assets of certain specified persons. Non-governmental organisations involved in the prevention of illicit capital flows include the Tax Justice Network, Global Financial Integrity, Publish What You Pay, Global Witness and Transparency International.

25 AIV advisory report no. 85, 'Crime, Corruption and Instability: An Exploratory Report', The Hague, May 2013, pp. 62-74.

IV The role of foreign capital in low-income countries

International capital flows are an important part of the international financial system.[26] They are the product of supply and demand, in which the level of supply depends on a number of global push factors and the level of demand depends on certain national pull factors. They are bolstered by the liberalisation of international capital movements, the improved monetary and macroeconomic policies pursued by certain countries, and the emergence of worldwide investors such as investment banks, pension funds, insurance companies, hedge funds and venture capital funds.

Generally speaking, domestic savings in low-income countries are limited and short term. At the same time, such countries have a tremendous need for capital for long-term investments, for example in infrastructure and small and medium-sized businesses, and also for capital accompanied by transfers of knowledge and technology. For this reason, foreign capital may form a welcome addition under certain conditions. However, since the outbreak of the financial crisis in 2008, people have come to acknowledge that the presence of foreign capital may also have an adverse effect and that it is possible to have 'too much of a good thing'.

There are three types of capital flow:[27]
1. foreign direct investment (FDI);
2. loans from banks and international financial institutions, also known as debt flows;
3. securities transactions, such as short-term trading in equities and corporate and government bonds, including trading in derivatives.

The first of these, FDI, generally helps a great deal in fostering economic growth. This type of investment is usually a stable, long-term source of finance. The two others types of capital flow, i.e. debt flows and securities transactions, are generally of a short-term nature and highly volatile, i.e. liable to extreme fluctuation.

As the name suggests, the second category, i.e. debt flows, leads to an accumulation of foreign debt. Whether this debt is sustainable in the long term is the key point here. In order for it to have the maximum impact on economic growth and development, the capital should be used so that it generates a high enough return, i.e. higher than the repayment commitments. If it does not, i.e. if it is used for consumption purposes or for non-profitable (prestige) projects for example, the result may be an untenable level of debt. The inflow of capital may even be counterproductive if it exerts upward pressure on the value of the country's currency and hence hampers its exports.

In other words, the pace and scale of the inflow of capital should not be greater than the additional investments that can productively be achieved with it. Governments and businesses that raise capital will need to make their own assessments of the likely future return. Initial overoptimism may lead to problems at a later stage. Capital providers have

26 See Annexe IV, especially sections 7 to 10, for background information.

27 Trade finance is not regarded as constituting an international capital flow. The amount of trade finance granted to a country may be derived from the difference between the trade balance based on accrual accounting and that based on cash accounting.

their own responsibility in this respect – some people would even say that they have a duty of care.

The figures indicate a sharp rise in international capital flows during the period up to 2007. During the years leading up to the crisis, the influx of capital into developing countries and emerging economies rose from USD 300 billion in 2002 to USD 1,400 billion in 2007. By and large, the capital went to just a small number of mineral-rich, middle-income countries. The capital flows to low-income countries have always been much more modest, due to the fact that these countries are much less integrated into the world economy. This had the advantage, incidentally, that they were largely unaffected by the financial crisis in 2008. Unfortunately, the crisis did have an indirect impact, in the form of lower demand for raw materials and, more especially, greater volatility of incoming capital flows.

The international financial system has a huge impact on all this. The monetary easing policies adopted by a number of Western countries, notably the US, have sent interest rates around the world plunging to historic lows. As a result, capital has gone in search of higher returns. Although some of it found its way to emerging economies such as Brazil, Turkey and Indonesia and even a small number of low-income countries, it got out again pretty quickly when panic reactions struck. Indeed, capital flows suffer from a deep-rooted affliction: their inherently procyclical behaviour. One of the causes of this market imperfection is lack of information. Investment is a highly information-intensive activity, but information is not always complete. This allows more room for sentiments: it is simply a fact of life that, when a boom is in full swing, investors tend to take a rosy view of future returns. This can fuel capital movements that may with hindsight prove be excessive, and which the IMF believes are driven primarily by supply-side factors.

With a view to breaking the pattern of boom-and-bust cycles, there is a growing consensus that developing countries might in certain situations wish to regulate the influx of capital. The guidelines issued by both the IMF and the FSB in this regard indicate that countries should start by pursuing a counter-cyclical policy and that capital regulation should be used as a last resort. There are two major problems here: first, the worldwide supply of capital is so vast that measures adopted by individual countries – particularly relatively small economies – are not capable of protecting the country in question from all the pressure. Major suppliers of capital (the US in particular) have therefore been urged to restrict their capital outflows. The second problem is the lack of regulation of outgoing capital. No international agreements have been reached, nor have any international guidelines been published, on capital outflows.[28]

So are any aspects of the international financial architecture systematically detrimental to the interests of low-income countries? Not ostensibly, as all countries are subject to the same formal rules. Nonetheless, the way in which credit risks are perceived may have a decisive effect on potential lenders. The risks pertaining to low-income countries are generally perceived as being higher than they are in practice. It is this aspect that has led to criticism of the credit-rating agencies, which some have said are prejudiced

28 S. Griffith-Jones, 'The case for prudent financial liberalization and its policy implications', Berlin Finance and Development Conference, 11 December 2013.

in their opinions.[29] Criticisms have also been voiced about the divergent risk categories adopted by certain regulators.[30]

The flow of incoming capital in low-income countries does not consist solely of private investments, however. It also includes aid from public-sector donors (indeed, in some cases this accounts for the bulk of the incoming capital). Remittances, i.e. payments from friends or relatives working abroad, are also a major source of income. The international financial architecture has no more than an indirect bearing on these two types of capital flow. The potential interactions between ODA and the international financial architecture include the disruptive effect ODA might have on the market for international capital flows, the international financial institutions' own contributions to ODA, and the policy influence exerted by these institutions on the spending of ODA. Remittances, for their part, benefit from a reliable and unconstrained system of international payments and are affected by national tax laws.

Counterposing the influx of capital is the outflow of capital. The scale of these outgoing capital flows is a cause of concern for many low-income countries.[31] The motives for many capital outflows include a desire to pay less income and/or wealth tax and/or the risk of capital being confiscated by the authorities due to corruption, war or economic mismanagement. Large sums of money are often involved in schemes aimed at avoiding national taxes by setting up international groups of companies and manipulating the transfer prices charged on intergroup transactions. Incidentally, this is not a problem that affects only low-income countries, as was illustrated by the recent outcry in the UK surrounding Starbucks' practice of shifting its profits to low-tax jurisdictions. The international financial architecture is undermined by illicit capital flows, i.e. movements of capital that are contrary to current restrictions or international agreements on the prevention of money laundering.

29 One of the big Dutch banks claimed in an interview that their African trade debtors were more reliable payers than certain debtors from more developed countries (October 2013). See also: *The Economist*, 19 April 2014, p. 66.

30 Even in the EU, some central banks classify certain debtor countries differently from others.

31 As the AIV wrote in its advisory report no. 69 'Cohesion in International Cooperation: Response to the WRR (Advisory Council on Government Policy) report "Less Pretension, More Ambition"', Africa's GNP was 7-8% lower in 2007 due to illegal money flows stemming from tax havens and the wrong prices being charged for goods and services. The problem may be much larger than corruption alone. It is caused by a lack of cohesion among national legal systems enabling international companies to reduce their aggregate tax burden. In response to a request from the G20, the OECD presented a plan of action in July 2013 (known as the 'Base Erosion and Profit Shifting Project') setting out 15 ways of preventing undesirable forms of interstate profit-shifting by multinationals. The Netherlands has pledged to assist with a number of these through the active participation of representatives of the Ministry of Finance and the Tax and Customs Administration in a number of committees. See: 'Internationaal fiscaal (verdrags) beleid' ('International tax treaty policy'), letter of 30 August 2013 (ref. EK 25.087) from the State Secretary for Finance and the Minister for Foreign Trade and Development Cooperation to the Senate of the States General. The letter includes the following statement: '*The Netherlands should critically examine its own actions. In certain cases, one is entitled to question whether it is in the spirit of Dutch law and in accordance with the wishes of the Treaty States that certain link companies established in the Netherlands should make use of the Dutch treaty network*.'

Finally, there are indications that trade finance accounts for up to 80% of the debts of certain developing countries.[32] The Basel rules on bank supervision make trade finance fairly easy to grant as the goods being traded can often be used as collateral. The new Basel capital ratio requirements may restrict the opportunities for granting trade finance, and this could affect low-income countries. Certain imports are financed by exporting companies, some of which are able to offer concessional loans on behalf of their governments, which are keen to promote their country's exports.

32 80% of the debt burden originates from transactions based on Economic Cooperation Agreements (ECAs) between the EU and the ACP (African, Caribbean and Pacific) group of countries. See: Øygunn Sundsbø Brynildsen, 'Exporting goods or exporting debts? Export Credit Agencies and the roots of developing country debt', Eurodad Report, December 2011.

V The effects of the international financial system on low-income countries

The effects of the instability of cross-border capital movements on the real economy
When do fluctuations in capital movements have an exclusively monetary impact? At what point do they damage the real economy, growth and employment? The experiences of countries such as India, Turkey and Brazil show how difficult it is to strike a balance.[33] Economic growth in these countries has been stifled by an excess of capital coupled with wide fluctuations in capital inflows and outflows. However welcome capital may be in low-income countries, they would be advised to learn from the experiences of middle-income countries, and consider pursuing a counter-cyclical policy and curbing incoming capital flows if necessary.

A country's domestic financial sector plays a key role in this respect. As both the facilitator of and/or the counterparty for international capital movements, it feels the direct effects of the international financial system, such as stricter bank supervision. It is also a breeding ground for the financial expertise that is indispensable if a country is to have a more effective voice in the international architecture. It is now regarded more or less as an omission if a macroeconomic model does not include a financial sector.[34]

The international financial architecture can foster stability by encouraging international financial institutions (including funds that help to cushion external shocks) to grant counter-cyclical loans, by giving advice and by regulating international capital movements (on both the supply and the demand side).

The composition of the local banking industry: public vs. private banks
Banks play an important social role and have a generally accepted 'duty of care' towards their customers. However, the latter is not always consistent with the market forces to which banks are subject. For example, security is lenders' highest priority, rather than maximising the social return. That is why there is a need, as is felt in the West for example, for public institutions to operate alongside commercial players.[35] Indeed, international financial institutions may also be regarded as public complements to the international financial markets. Central banks are also public banks.

Public development banks with non-commercial objectives are active in most low-income countries. These may distort markets and lead to a sub-optimum allocation of capital. The nature of their products (i.e. loans) and the lack of competitive and market forces open up these development banks to political influence. This may encourage corruption and moral hazard, i.e. a tendency to take risks with impunity. However, one could equally claim that, as used to be the case in the Netherlands, public development banks form

33 See Annexe IV, especially section 10, for an explanation.

34 See, in relation to the Netherlands, the work of Dirk Bezemer of the University of Groningen in particular.

35 All the big Dutch high-street banks have public or social roots. One of ABN AMRO's legal predecessors is the Nederlandse Handel-Maatschappij ('Dutch Trading Company') founded by King Willem I, while ING Bank originates from Nederlandsche Middenstandsbank and Postbank (both founded by the government), Rabobank has its roots in farmers' cooperatives serving the public interest, and NIBC used to be known as the 'Dutch reconstruction bank'.

an important complement to an as yet imperfect commercial sector.

These public development banks generally receive support not just from international financial institutions, but also from donor countries. For example, KfW in Germany and FMO (Entrepreneurial Development Bank) in the Netherlands are both closely involved in the growth of local development banks, including local private banks. Using a combination of knowledge sharing and tough conditions, they are introducing 'sustainable and inclusive lending'.[36] IFC and FMO are regarded as pioneers in this field. This form of international aid should be encouraged, and new aid instruments such as guarantees are a particularly suitable form of support.

The composition of the local banking industry: foreign vs. domestic banks
Another aspect to bear in mind is the composition of the domestic financial sector: there needs to be a good division of responsibilities between domestic and foreign players, without this resulting in domestic oligopolies or monopolies (as also occurs in Western countries) or in foreign players dominating the market. A diverse banking industry enables banks to service a broader group of customers, encourages competition and spreads risks. Foreign banks may be represented in the form of branch offices or subsidiaries, with the former being supervised by the regulatory authority responsible for the parent bank, and the latter being supervised by a local regulatory authority.

As the economies of low-income countries are relatively small, so their domestic banks are usually also small, particularly when compared with international banks. The size difference creates a number of competitive problems:

- less easy access to the international capital market, as there are no big (deep) trading opportunities in the debt issued by these banks;
- the relatively high cost of regulatory compliance (bigger banks have their own specialist compliance departments);
- the relatively high cost of capital- and knowledge-intensive automation;
- a higher cost of capital due to the higher degree of perceived risk (irrespective of whether or not this is justified).

On the other hand, domestic banks also have certain advantages in that they are familiar with the local language and culture and have their own local networks. In other words, it is possible to achieve a high degree of complementarity between the financial services offered by foreign and domestic banks, with the former providing services in support of international trade and investments, for example.

The national financial authorities can ensure that the domestic banking industry has a balanced composition by attaching certain conditions to the banking licences they issue. However, the freedom of manoeuvre may be restricted by the provisions of international treaties demanding the liberalisation of the national financial sector, for example by allowing international banks (more or less) free access to the market.[37]

36 The term 'sustainable' refers mainly to the policy of minimising the ecological footprint, while the term 'inclusive' refers to the principle that all sections of the population should benefit from the fruits of economic activity.

37 In this sense, the international financial system can have a huge impact on the domestic financial system. It is not always a reciprocal relationship, though. This is one of the issues that have been raised during the renegotiation of ECAs and the Transatlantic Trade Pact.

Innovative financial services
Financial products such as derivatives can help developing countries to gain access to the international capital market. FMO's highly acclaimed TCX fund is a good example: it enables certain developing countries to hedge their foreign-exchange risks. Mobile payment systems are another valuable innovation and have become very popular in countries such as Kenya. In many cases, they have been launched by telecoms operators.[38] They do not require a banking licence, are not subject to banking regulation and may be seen as a form of 'shadow banking'. Given that their use quickly leads to the formation of deposits and savings, lending services are only a small step away. Obviously, mobile payments systems created by official banks are supervised by banking regulators.

Micro-credits have also become more important in many low-income countries. In some instances, these are provided by local and/or foreign NGOs which are aware that this form of lending is not sufficiently attractive to commercial banks. The majority of micro-credit lenders do not hold a banking licence and are not subject to banking supervision. This limits their opportunities for expanding their businesses by attracting savings deposits, which means they remain dependent on subsidised capital, either from their own country or from abroad. A recent World Bank study into the effects of micro-credits in Bangladesh found that they had a number of positive effects such as higher household spending, greater household wealth, more jobs and better education for children. Women were found to benefit the most from them.[39]

Mobile payment systems, micro-credits and other innovative financial services should be encouraged and supported by the international financial architecture. This could be in the form of advice and loans from international financial institutions, for example, and assistance with the development of specially adapted forms of supervision.

The importance of supervision
Bank supervision is indispensable for generating confidence and is a crucial condition in international financial transactions such as trade finance. At the same time, supervision is a complex business, in terms not only of formulating regulations, but also of enforcing them. International bank transactions require coherent supervisory regulations. In practice, many countries (including low-income countries) have adopted the supervisory model proposed by the Basel Committee on Banking Supervision as their starting point.

Banking supervision has to be made to measure. Rules and regulations devised for Western banks cannot simply be applied to banks in low-income countries. The differences between them are too great. The verbatim application of the Basel III supervisory rules would place domestic banks in low-income countries at a competitive disadvantage. However, Basel III does set certain extra requirements as a result of which it is precisely the large, international banks that are most apprehensive about their adoption. A specially adapted, 'lighter' form of the Basel rules could be developed for smaller countries and banks, in line with their own local institutions and laws. The point here is to strike the right balance between regulation and the stimulation of

38 According to the UN's Universal Postal Union, some 1 billion people in 50 countries depend on postal companies for their financial services. *The Economist*, 19 April 2014, p. 66.

39 S. Khandker and H. Samad (2014), 'Dynamic effects of microcredit in Bangladesh', World Bank Policy Research Working Paper 6821.

economic growth,[40] and to generate sufficient confidence to ensure that the institutions covered by the special rules do not have to pay a higher risk premium for their loans.

There is a need for new forms of regulation for innovative financial services. The aim is to prevent potential abuses,[41] reduce dependence on non-commercial institutions, create opportunities for managing savings and other deposits and for paying interest on credit balances, and allow banks to build up credit histories so that they can gain access to credit in the future. In the Netherlands, for example, the De Nederlandsche Bank has developed a 'light' form of supervision for 'credit unions'.

The international financial architecture could help with the development of these specially adapted forms of supervision. The Basel Committee on Banking Supervision could, in designing its supervisory models, take greater heed of the situation in low-income countries and their banking sectors.[42] An institution such as the IMF could offer specially tailored assistance in designing and implementing adapted forms of supervision in low-income countries and in training independent supervisors with the necessary expertise.[43]

From the perspective of coherence, the guidelines drawn up by the IMF and the FSB in the wake of the 2008 crisis for controlling international capital movements, particularly the inflow of capital, need to be properly integrated with the regulations for supervising the domestic financial sectors of low-income countries.[44]

Conditions for the development of local financial sectors: the need for a national step by step plan

National financial sectors often comprise more than banks alone. They usually include insurance companies, pension funds, stock exchanges and other markets in financial products. They are very important in generating local savings. Long-term savings in particular – such as pension funds – generate capital that can be used for long-term investments.

40 As Stephen Spratt writes, 'Regulation should fit the size, complexity and systemic risk of institutions, but be light enough to encourage innovative business models', in: 'How does financial regulation in low-income countries affect growth and financial stability?', in: D.W. te Velde and S. Griffith-Jones (eds.), *Sustaining growth and structural transformation in Africa: how can a stable and efficient financial sector help?*, Current policy and research debates, DEGRP Policy Essays: December 2013.

41 In 2012, Grameen Bank fell foul of the Bangladeshi government, which alleged that the Bank had followed a number of unsanctioned practices in the past. In April 2014, the government placed Grameen Bank's board under central bank control.

42 The Basel Committee on Banking Supervision has performed studies of the desirability of and opportunities for specially adapted forms of supervision in relation to micro-credits.

43 The Netherlands is making a financial contribution to the IMF's Capacity-Building Initiative for Africa, which operates through three Regional Technical Assistance Centers.

44 S. Griffith-Jones, 'The case for prudent financial liberalization and its policy implications', Berlin Finance and Development Conference, December 2013, p. 17.

Once a national financial market gains a certain degree of 'depth' and liquidity, it becomes attractive to foreign capital. International confidence in national financial institutions is bolstered by stable macroeconomic and monetary policies, the effective rule of law (including respect for ownership rights), anti-corruption campaigns and the presence of independent auditors for verifying and valuing assets. Unfortunately, many low-income countries still lag behind in terms of ease of doing business and corruption perspective.[45] These countries would therefore be well advised to adopt a step-by-step plan for putting their own financial sector in order. The international financial architecture can further this process by providing loans and giving advice. The Netherlands could also assist, by sharing its expertise in relation to pension schemes and cooperative financial services.

45 See Annexe IV, section 10.

VI The importance of coherence and global governance

The sharp increase in the scale of capital movements and the interdependence of the world's financial markets and institutions has destabilised the 'old' international economic and financial system. This was underlined by the financial crisis in 2008. The growing trend towards intergovernmental governance by major powers such as the US, culminating in the G20, has undermined the authority of the IMF and the World Bank, as well as the representativeness of their decisions.

The international economic and financial system has been placed under further pressure by the much wider gap not just between developed and developing countries, but also among developing countries themselves. The AIV stressed the importance of global governance in its advisory report on the post-2015 development agenda ('The Millennium Development Goals in Perspective'). The AIV also organised a symposium on the operation of the international financial system on 8 March 2013.[46]

An authoritative report published by the Oxford Martin Commission for Future Generations (known as the 'Lamy Report')[47] points to the absence of robust global supervisory mechanisms in the international financial architecture. It concludes that the 2008 crisis was fuelled by policy failures in the West and the inadequate financial controls applied by multilateral institutions. At times, regulators were unable to get a grip on new, complex financial products. Private financial institutions mounted a powerful lobby.[48]

The crisis in 2008 lent fresh urgency to the need for internationally coordinated action and increased the burden placed on the currently highly influential FSB. This has led to the explicit addition of a third pillar to the architecture of the international financial system, in the form of macro-prudential supervision aimed at preventing and tackling financial chain reactions.

46 See: AIV advisory report no. 74, 'The Post-2015 Development Agenda: The Millennium Development Goals in Perspective', The Hague, April 2011; AIV advisory report no. 80, 'Unequal Worlds: Poverty, Growth, Inequality and the Role of International Cooperation', The Hague, September 2012; and 'De werking van het internationale financiële stelsel' ('The operation of the international financial system'), report on an AIV symposium held on 8 March 2013.

47 Report of the Oxford Martin School, 'Now for the Long Term', 2013, p. 42. The Commission for Future Generations was made up of 19 global experts including Pascal Lamy, Jean-Claude Trichet, Amartya Sen, Mo Ibrahim, Trevor Manuel, Kishore Magbubani and Nicholas Stern.

48 See, for example, the report entitled 'The Fire Power of the Financial Lobby' published by Corporate Europe Observatory, quoted in NRC on 11 April 2014; and 'Banken lobbyen met succes tegen strenge regels' ('Banks successfully lobby against strict rules'), NRC, 31 January 2014.

The following table shows just how fragmented the governance of the international financial system is:

Institution	Object/role	Membership	Authority	Voting
IMF	International financial stability	Virtually all countries	Partly supranational	Based on financial contributions
World Bank	Development	Virtually all countries	Partly supranational	Based on % share of equity capital
FSB	International financial stability	G20 +	Intergovernmental	Consensus
Paris Club	Debt restructuring	Creditor countries	Binding agreements	Consensus
FATF	Prevention of money laundering	OECD, BRICS and a few others	Advisory	Consensus
Basel Committee	Bank supervision and financial stability	27 rich countries	Guidelines	Consensus
UN/ ECOSOC	Economic development and stability	Universal	Political agreement	One vote per country

Strengthening the position of low-income countries in the current system[49]
Private capital flows to low-income countries are the result of both global supply factors and domestic demand factors. To a large extent, the supply of capital is dictated by expectations about changes in monetary policy, such as the West's decision to end monetary easing. Not enough attention is given at present to the impact of monetary policies on developing countries. Although it is a topic of debate in international forums such as the G20 and the World Economic Forum, it does not figure on the agendas of national bodies in the West because policymakers and politicians feel that cross-border effects are not part of their mandates. The AIV would like to see more attention paid to the issue of co-responsibility (i.e. the duty of care) for the immediate external impact on poor and vulnerable countries. There are purely economic reasons for this as well as ethical motives. The secondary external impacts can affect a country's own economy, for example if they trigger a decline in the volume of trade or an increase in financial instability.

49 The ideas presented in this section were discussed at a workshop on 'Policy Coherence and International Financial Architecture' organised by the Overseas Development Institute (ODI) in London on 31 January 2014.

The G20 would therefore have more to contribute to the financial section of the post-2015 development agenda if a new set of agreements could be reached with the poorer developing countries. Moreover, the G20 would be more representative if it adopted a system of constituencies or were replaced by a Global Economic Coordination Council. This would enable the agenda to focus on encouraging sustainable, inclusive investments in low-income countries, managing capital flows and monetary policy in a more coordinated way, and resolving the problem of tax evasion and capital flight. As far as the latter point is concerned, the G20 called for a global plan of action back in 2011 in order to prevent the tax base from being eroded and profits from being diverted to low-tax jurisdictions.

The influence exerted by low-income countries in the international financial architecture is a recurring topic of debate. Their influence hinges on their relative importance in the global economy.[50] It would be in the interests of both reforms and stability if they were to have more influence. The FSB identified a number of major shortcomings in 2011 and 2012, in reforms as well as in other areas, that had – sometimes unintended – effects on low-income countries. These problems included the adjustment of the Basel III regulations to national capacities, and the spillover effects on risk and credit management in these countries,[51] and on their rating by credit risk agencies.[52] The FSB called for broader responsibility for macro-prudential supervision and guarding against systemic risks. Although these problems have been acknowledged, little action has so far been taken to tackle them in a truly integrated manner outside Europe. The FSB tends to concentrate on the larger middle-income countries, many of which have relatively well-developed and internationally integrated financial systems. In this context, there would appear to be good grounds for strengthening the position of low-income countries. This is certainly possible, for example by co-opting representatives of these countries to the Basel Committees and various subcommittees. However, influence is not merely a question of voting rights. Given the complexity of the subject matter, expert representatives, particularly if they took a non-partisan approach, would be able to make high-quality contributions to the work of these committees that might sometimes carry more weight than the equivalent number of votes.

Expanding existing facilities

The international financial institutions have adopted some major policy changes in response to the financial crisis of 2008. These include an expansion of counter-cyclical lending, and the reform and modernisation of lending facilities. Some commentators have also called for the further strengthening of ‘shock funds’ designed to enable low-income countries to absorb external shocks, while others have proposed new types of

50 For example, of the 27 countries whose central banks have a seat on the Basel Committee for Banking Supervision, seven are middle-income countries. Not a single low-income country is represented. The picture is the same with regard to the 24 member countries of the FSB.

51 Particularly the application of the ‘Volcker rule’, which imposes certain restrictions on banks owning hedge funds and private equity funds.

52 FSB, ‘Financial Stability Issues in Emerging Market and Developing Economies’, Report to the G20 Finance Ministers and Central Bank Governors, 20 October 2011. See: <http://www.financialstabilityboard.org/publications/r_111019.pdf>. FSB, ‘Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences’, Report to the G20 Finance Ministers and Central Bank Governors, 19 June 2012. See: <http://www.financialstabilityboard.org/publications/r_120619e.pdf>.

concessional loans.[53] Despite the benefits that relatively poor countries derive from concessional IMF loans, they sometimes have the disadvantage of imposing overly restrictive conditions on certain domestic macroeconomic issues.[54]

Long-term loans are essential for structural investments in low-income countries, particularly for investments in infrastructure, green technologies and public services such as health care and education. The international economic and financial system should strive to boost both the size and the stability of private capital flows to low-income countries, including foreign direct investment (FDI) and government bond issues. This would entail developed member states providing permanent support for concessional loans, particularly long-term loans such as the World Bank's IDA loans and similar loans granted by regional banks, as well as the combined public-private forms of finance provided by the IFC and the FMO. These are a vital additional means of gaining access to 'missing markets', given that private-sector loans are subject to uncertainties about their size, cost and maturity due to the volatile moods of international investors. The non-concessional nature of new bond issues means that they may also help to create an unsustainable level of debt.

The governing bodies of the international financial institutions, and the associated political consultative bodies (such as the FSB), need to give greater attention to these problems so that low-income countries can continue to raise long-term and concessional loans. Boosting the capacity of domestic institutions in low-income countries to manage financial risks and hence regaining the confidence of foreign investors should be a regular agenda item for the international institutions. Both the planning and the implementation of macroeconomic management should be improved. Capital accounts need to be carefully managed, so as to make better use of the positive effects of incoming capital flows and avoid any wide fluctuations in the level of outflows. Regulation and financial incentives (such as tax relief) can encourage banks and other domestic lenders to focus on sustainable and inclusive investments.

Private domestic financial institutions, particularly large ones, have an interest in better micro-prudential[55] regulation and supervision, including improved monitoring and risk management. There is also a need for building macro-prudential capacity, so that the financial standards enshrined in Basel III are adapted to the situation in low-income countries and to innovative financial services that are important to such countries, such as mobile payments and micro-credits.

53 S. Griffith-Jones and J. A. Ocampo, 'The International Financial Architecture Seen through the Lens of the Crisis: Some Achievements and Numerous Challenges', in J. Alonso & J.A. Ocampo (eds.), *Development Cooperation in Times of Crisis: Initiative for Policy Dialogue*. New York: Columbia University, 2012.

54 The question is not whether no conditions should be imposed (after all, conditionality is needed to avoid moral hazard), but rather whether the conditions imposed as part of emergency relief programmes for coping with external shocks may cover certain areas that do not fall within the IMF's remit. These are what are known as 'structural conditions'. In 2008-2010, IMF programmes included an average of 15 structural conditions, as compared with an average of 17 during the period from 1995 to 2004. Many countries regard this as an insignificant improvement.

55 Micro-prudential means 'geared to the health of an individual institution'. Macro-prudential supervision is geared towards the stability of an economy or the financial system as a whole.

The latter aspect is becoming increasingly important. More and more new forms and structures are starting to appear on the market. For example, guarantee and insurance programmes have proved to be an effective tool for private investors supplying capital for development purposes, including for the development of sectors and countries, and for high-risk public-private investment projects.[56] Other new instruments, such as venture capital, equity funds and innovative risk management programmes for terms of trade and political risks, already have a successful track record. There is scope for further developing all these various initiatives, with the backing of Dutch bilateral or multilateral programmes.

Wider aspects of global economic and financial governance
Referring to the G20 in a lecture given at an AIV symposium held in March 2013, the former UN Under-Secretary-General, Professor José Ocampo, said that, regardless of how 'representative' an informal dialogue mechanism may be, or how powerful its members may be, this type of informal dialogue platform cannot replace regular, multilateral decision-making procedures in formally established international organisations. This aspect lies at the heart of the G20's weakness. Despite its political coverage, the fact that the body does not have a treaty with the UN means that it has neither the mandate nor the legal authority required to enforce its decisions. This creates serious problems in terms of legitimacy and the erosion of more democratic – and more effective – existing governance structures.[57] This is why Professor Ocampo insisted that the G20's main task should be to strengthen existing international bodies (of which all its members are also members), so that the latter can assume responsibility for the tasks performed by the G20 during the crisis. In other words, the G20's aim should be to make itself redundant by improving essential global governance structures.

Precisely for this reason, one of the recommendations made by a commission of experts instituted by the President of the UN General Assembly to reform the international monetary and financial system[58] was to set up a Global Economic Coordination Council (GECC) with a restricted and partially rotating membership. This type of body was to perform, albeit more effectively, the role that the G20 had arrogated for itself and would have the same ability to focus its attention at any time on vital economic and financial issues that require leadership at the highest political level and transcend the institutional boundaries of the various international bodies. Unlike the G20, its formal structure would be acceptable to low-income countries and it would not undermine the system of global governance. For this reason, the AIV urges the government to gives its backing in the various international bodies to the establishment of a GECC.

56 World Bank (2009), 'World Bank Group Guarantee Instruments: 1990-2007: An Independent Evaluation', Washington: The World Bank Publication. See: <http://www.scribd.com/doc/17512164/World-Bank-Group-Guarantee-Instruments19902007-An-Independent-Evaluation>.

57 For this reason, in a properly designed international economic governance architecture, informal dialogues should be subordinate to formal decision-making processes. This means not only that the results of these informal dialogues should ultimately be adopted by treaty-based organisations, but also that these organisations' decision-making processes should be fully respected.

58 UN, 'Report of the Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System', New York, 21 September 2009. See: <http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf>. This Commission of Experts was supported by the Dutch government.

Retaining the IMF's role, but in an adapted form, is another issue. Discussions in the commission of experts indicated that there was support for a stronger role for the IMF in a system of strengthened global governance – whether in the shape of a new GECC or otherwise. The IMF has changed its policies, or in any event proposed certain policy changes, notably in the wake of the 2008 crisis, in relation to stimulating demand on a counter-cyclical basis in times of recession, restricting excessive short-term capital inflows into developing countries, and recognising the need for viewing income and gender distribution issues as social and macroeconomic problems. These policy changes also appear to be relevant to low-income countries.

The AIV expects the following issues to dominate the international agenda in the near future:

- **Voting rights in the IMF**: The proposal by a committee chaired by the South African minister, Trevor Manuel, to raise developing countries' voice and quota shares by 3.9% and 5.3% respectively has been deferred pending approval from the US Congress.[59] This has annoyed emerging economies such as China and India, which have yet to see their new positions in the global economy reflected by changes in the international economic and financial system.

- **Regional financing arrangements**: This frustration has fuelled a desire to set up regional networks such as the Chiang Mai scheme. These are liable to run into difficulties if a particular balance of payments problem affects the global balance of payments, resulting in the dilution of scarce competencies, a surfeit of meetings and the threat of turf wars. This could weaken the coherence of global governance, create more highly fragmented and decentralised regulatory regimes,[60] and undermine financial stability. For this reason, the AIV believes that it is in the interests of the West (including the Netherlands) to demand rapid reforms at the IMF – and the World Bank for that matter – so as to enhance the voice of emerging economies and thus prevent the otherwise inevitable fragmentation of institutions.

- **Special Drawing Rights (SDRs)**: With a view to reducing the volatility of the international system, proposals have been made for giving a more prominent role to special drawing rights and making better use of them. The 2009 G20 summit in London took the first step in this direction. Even though this led to the biggest ever increase in SDRs, they still do not account for more than 4% of the Fund's non-gold reserves. The AIV believes there are at least three reasons for raising the profile of SDRs:
  (i) if the international monetary system were based on SDRs, it would be better able to cope with the potentially adverse effects of US monetary policy;

59 See also: T. Manuel (2010), 'Macro Lessons from the Financial Crisis', in B. Berensen (ed.) (2010), *Economic Growth and the Common Good: From Crisis to Sustainable Development*, Amsterdam: KIT publishers for SID; and *The Economist*, 28 March 2014.

60 N. Woods, 'Global Institutions after the Crisis', *Het Financieele Dagblad*, 13 September 2013.

(ii) issuing SDRs on a counter-cyclical basis would be a better means of counteracting the deflationary tendency of what remains an asymmetrical system of adjustments of national deficits and surpluses;[61] and
(iii) boosting the quantity of SDRs could reduce the need for the preventive accumulation of reserves.[62]

- **Debt restructuring**: the lack of a generally accepted 'debt work-out mechanism' is a major shortcoming in the international financial system. As the current crisis in Europe has demonstrated, it is not just low-income countries that would benefit from such a system. The West would, too.[63] The international system needs this type of mechanism because it cannot operate by emergency lending alone. The only formal mechanism for public debt restructuring is the Paris Club.[64] The institutional structure of a debt work-out mechanism could either take the form of a new international debt court or an existing international institution could be given the task of acting as an honest broker and (if need be) an arbitrator. The latter role is one that the IMF could perform. Unfortunately, despite the changes currently taking place at the IMF, the Fund is not universally regarded as impartial. For this reason, the AIV recommends setting up an independent panel of experts on the lines of the dispute settlement mechanism adopted by the World Trade Organization. This panel could be made responsible for mediating between debtors and creditors and for proposing solutions based on international agreements. The IMF could then be given the task of enforcing its decisions.

61 This would entail the creation of SDRs during a global recession and their destruction once the recession has come to an end. See: J.A. Ocampo, 'The Global Financial System', speech given during an AIV symposium on the operation of the international financial system, 8 March 2013.

62 Many countries, including low-income countries, have made substantial additions to their reserves in the wake of the Asian crisis as a buffer against future crises. Calculations by economists such as Dani Rodrik have shown that they could have achieved more economic growth by spending these reserves on development programmes instead of simply hoarding them. See D. Rodrik (2006), *International Economic Journal*, vol. 20(3), pp. 253-266.

63 UN, 'Report of the Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System', New York, 21 September 2009.
See: <http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf>.

64 A proposal made by the IMF in 2003 for a Sovereign Debt Resolution Mechanism did not garner sufficient support. Ad-hoc frameworks include the HIPC initiative, which was superseded by the Multilateral Debt Relief Initiative in 2005. Other measures taken include the incorporation of 'Collective Action Clauses' in bond loans and a private code of conduct known as the 'Principles for Stable Capital Flows and Fair Debt Restructuring', sponsored by the Institute of International Finance. There is, however, a need for a more comprehensive mechanism that would in principle cover all countries. See: J.A. Ocampo, 'Reforming the International Monetary System', 14th WIDER Annual Lecture, United Nations University World Institute for Economic Development, Helsinki, 10 December 2011.

VII Conclusions and recommendations

The previous chapters present a picture of an international economic and financial system that has failed to keep up with changing circumstances. Despite the adjustments made over the years, the system is looking increasingly outdated. Global financial stability has been undermined by trends such as the sharp increase in the volume of financial flows, the interweaving of financial markets, the accumulation of wealth, the sometimes excessive growth in the volume of cash in circulation due to quantitative easing, and the impact of trade surpluses (as in China) caused by strict adherence to excessively low exchange rates for national currencies. If one also factors into the equation the rapid expansion in inn ovative financial services (many of which are difficult to control), the growing number of treaties and institutions and the rise of regional financing arrangements, it becomes clear that the challenges are going to be just as complex in the future.

Will further – primarily reactive – adjustments to the current system be adequate? Or would the world be better served by a completely redesigned international financial architecture that safeguards the interests of a larger group of countries?

The AIV believes that there is no need to redesign the international economic and financial system. Having said that, the current system is in need of a thorough review, with certain aspects of the system possibly being combined in the future in order to prevent a situation in which (justifiable) dissatisfaction about elements of the system leads to further fragmentation and the erosion of the system as a whole. Reforms along these lines certainly appear to be feasible. The AIV believes that the key to success lies in achieving intergovernmental agreements on adjustments to policies and management structures, and possibly also on the creation of a supranational umbrella organisation.

However, the sharp drop in confidence in the financial sector among politicians and the general public makes it more difficult to adopt a clearer political position on changes in the international economic and financial system. Despite the measures taken by many governments to rebuild confidence in national economic and financial systems (such as stricter regulation, more extensive bank supervision, calls for financial institutions to cut back on staff pay and bonuses, and even bank takeovers), public confidence in national financial systems has yet to be restored. If public confidence were to be regained, this would make it easier to secure support for the desired changes in the international economic and financial system. The AIV therefore looks forward to the publication of a new report by the Scientific Council for Government Policy (WRR) on the consequences of 'financialisation' in the Netherlands. The report is due to be published sometime in 2015.

In short, the AIV believes that the key problems are:

(i) the **lack of a coherent and widely accepted perspective** on how global financial and economic stability should be achieved and sustainable economic growth should be fostered around the world;

(ii) the **absence of a clear, coherent and globally accepted agenda, including a list of higher and lesser priorities**, a problem exacerbated by the precedence given to national interests; and

(iii) an **inadequate management structure**, as reflected by the lack of effective and representative global supervisory mechanisms, among other things.

A problem that is specific to low-income countries is their relative lack of integration into the global economy. As a result, these countries did not feel the direct effects of the global crisis in 2008. However, they did notice the effects in later years, as a result of financial instability and violent fluctuations in capital flows around the world. Although the group of low-income countries as a whole witnessed a fivefold rise in the level of foreign direct investment within a 10-year period, there were nonetheless wide disparities among individual countries. There was no dramatic decline in the level of capital flows to these countries in the wake of the crisis, though they did become more volatile. Certain low-income countries even experienced a net outflow of capital, probably precipitated by the absence of markets and investment opportunities, tax motives and the risks of mismanagement. The external perception of their risk profile, which some commentators feel was overly pessimistic, also tended to check the inflow of capital. The AIV therefore believes that such countries would also benefit greatly from the adjustment of the international economic and financial system.

The answer to the question: 'Are the smaller emerging economies and poorer countries adequately represented in the current financial system?' is a wholehearted 'no'. Underrepresentation is a problem that applies just as much to many other countries. Middle-income countries, for example, also feel let down by the current system. Multilateral institutions such as the IMF and the World Bank are more representative than informal consultative bodies such as the G20. At the end of the day, countries are formally members of these institutions and are represented in constituencies. This is in contrast to a body such as the G20, whose managerial and decision-making processes take place largely without their involvement.

The recommendations made below apply to all developing countries, including the group of low-income countries. They follow from the realisation that market forces in the financial system are not sufficiently geared towards achieving and maintaining stability:
- capital flows tend to be procyclical;
- credit is attracted by favourable risk-return ratios and to a lesser degree by the most socially desirable investment opportunities; and
- technological advances lead to virtually uncontrollable growth in the volume and complexity of financial products, thereby triggering a rise in systemic risks and creating a need for constant adjustments to international regulations.

A number of the recommendations are concerned with making government interventions more powerful and more efficient, although the AIV accepts that this would entail certain counter-risks:
- moral hazard, i.e. making it possible to run certain financial risks with impunity, in the knowledge that governments will come to one's aid if necessary;
- the improper use of resources, abuse and corruption; and
- increasing complexity and administrative burdens, which could be limited by building expertise (or supporting that process).

Recommendations on global governance and representativeness

- **The government should support the formation of a Global Economic Coordination Council (GECC)**. A treaty-based organisation conceived along these lines would be better able to play the role that the G20 has arrogated for itself, and would have the same ability to focus its attention at any time on vital economic and financial issues that require leadership at the highest political level and transcend the institutional boundaries of the various international bodies.

- **The Netherlands should press for the FSB to be transformed into a global coordinating body**, or in any event into a global policymaking institution for the entire international financial system, in which all countries are represented on a proportionate basis. The aim of transforming the FSB along these lines would be to develop a generally accepted standpoint on how monetary and financial policy could be harmonised (i.e. between the dollar and the euro) and to formulate an agenda for coherent adjustments to relevant parts of the architecture. National reforms would form part of this.

- Since the adoption of the 1993 Vienna Declaration on Human Rights, it has been internationally recognised that human rights in a broad sense and the operation of the international economic and financial system are closely connected with each other. **Partly for this reason, the issue of governance should figure more prominently in the post-2015 development agenda. Recognising the importance of financing this agenda, the Netherlands could propose and perhaps organise a new UN conference on 'financing for development', analogous to the conference that was held to discuss the funding of the Millennium Development Goals.**

- **The Netherlands should continue to argue for SDRs to play a more important role, and for the dollar to play a less prominent role**. Although it is difficult for SDRs to additionally serve as a monetary tool for financing development and although the current reserves are relatively limited, the issue of SDRs could benefit low-income countries by giving them access to more stable reserve currencies.

- **The Netherlands should continue to press for the rapid adjustment of voting rights in the principal elements of the financial system**, such as the IMF and the World Bank. Western countries should free up more space for both emerging and recently emerged economies. If this does not happen, the IMF will lose its authority among these countries and international coordination will become more difficult. The Netherlands could set an example by agreeing to share its seat at the IMF.

- **The Netherlands should argue more vigorously for a universal debt work-out mechanism.** The lack of a generally accepted debt relief mechanism is a major shortcoming in the international financial system. As the current crisis in Europe has demonstrated, it is not just low-income countries that would benefit from such a system. The West would, too. A debt work-out mechanism could take several forms.

Recommendations to improve financial stability

- ***The Netherlands should use its influence in the FSB and the IMF to support initiatives leading to the prudent regulation of incoming capital flows***, with the aim of preventing sharp fluctuations in such flows. It should ensure that the latitude available to low-income countries in particular to regulate incoming capital flows is not totally constrained by the liberalisation requirements in international treaties.

- ***The Netherlands should also call for initiatives to regulate outgoing capital flows*** to a certain extent, again with the aim of preventing sharp fluctuations in such flows. Any regulations should apply worldwide, in the knowledge that this will enhance the stability of the system as a whole. This would benefit all countries, particularly the more vulnerable developing countries. Such regulations could help to reduce capital flight, although the latter is caused by a wide range of factors, many of which are difficult to control.

- The ***Netherlands should use its relatively strong voice in the Basel Committee for Banking Supervision to back measures leading to a reduction in the systemic risks posed by very large private financial institutions.***

- ***The Netherlands should continue to contribute to the IMF's counter-cyclical facilities as the last resort in mitigating wide fluctuations in capital flows to the most vulnerable developing countries***. The facilities should not create a situation in which countries can take ill-advised credit risks with impunity.

Assistance with the development of domestic financial sectors

- Recognising that the governments of developing countries are primarily responsible for the balanced composition of the banking industry in their countries, ***the Netherlands could pursue a dialogue with these governments calling for the objectives of the supervisory mechanism to be extended to include growth and job creation alongside the containment of inflation.***

- ***The Netherlands could use its position in multilateral development banks (such as the World Bank and regional development banks) to argue for these institutions to pay sufficient attention to the above aspects of the development of domestic financial sectors.***

- ***The Netherlands could offer expertise and financial support*** for the further development of supervisory mechanisms specifically geared to the situation in low-income countries, and also of innovative financial services such as mobile payment systems, the development of pension schemes, inclusive and gender-sensitive lending and cooperative forms of banking and insurance. In consultation with the big banks, a study could be conducted to see whether a new type of instrument such as a guarantee could help raise finance for low-income countries on the international markets, while taking corporate social responsibility and transparency requirements into account.

Coherence at home

It became clear, during the preparatory work for this report and the interviews with experts, that, both in the Netherlands and in other countries, opinions on the issues discussed in this report tend to diverge. Among the main reasons for this are the political and economic role played by the financial sector, and the complexity of the subject matter. Proper, constructive debate is undermined by incomplete information and lack of awareness of one another views.

For this reason, the AIV urges the government to initiate and facilitate a consultative structure that would provide a better platform for distributing and discussing such information. The government could invite as participants Dutch representatives involved with the aspects of the international financial architecture discussed in this report, as well as a number of their counterparts from the South and representatives of large Dutch banks and civil-society organisations that are well-informed but critical followers of the system. The government could also support further research into the position of low-income countries in the international financial system and could make proposals for improving their position. This could enhance the coherence of Dutch contributions to the international economic and financial system. Presenting the findings of such meetings and research in international forums might help to speed up the process of making the necessary adjustments to the system. Although the road ahead is long and arduous, the benefits could be substantial.

Request for advice

Mr F. Korthals Altes
Chairman of the Advisory Council
on International Affairs
P.O. Box 20061
2500 EB The Hague

Date 27 August 2013
Re Request for advice

Dear Mr Korthals Altes,

I am writing to ask the Advisory Council on International Affairs (AIV) to prepare an advisory report on the coherence of the international economic and financial architecture.

Shifts in the global economic and political balance of power are putting pressure on the international economic and financial architecture. The recent financial crisis has demonstrated the need for stronger global governance in this area, but the increasing number of players complicates the decision-making process. Large, emerging countries like the BRICS are demanding greater influence and choosing to go their own way. National political interests dominate international decision-making, giving rise to the question of who represents the interests of developing countries in this evolving system.

The smaller emerging countries and the poorest countries are particularly vulnerable in the current global economic and financial landscape. In order to stay a part of the global economy, they have no choice but to remain highly dependent on external markets and financial flows. At the same time they need stability, protection from economic shocks, and the freedom to shape their own policy. The instability that has marked the system in recent years is, of course, unfavourable for all countries, but it is especially detrimental for the development of this group. Open markets, risk financing, stability funds and debt management schemes are vital to their prospects for growth and development. In the years ahead, the system of trade, investment and other types of private financing will only become more important to these countries, as the significance of traditional ODA declines. Three elements of the financial system are especially significant to development policy: the stability of financial markets, development financing through the international financial institutions, and the financing of global public goods.

Although they have major interests at stake, most developing countries do not always have a place at the table when it comes to making decisions about changing the international economic system. This is particularly true of low-income countries and developing economics that exhibit growth but are too small to be part of the BRICS group. Major innovations prompted by the recent crisis have, to some extent, passed them by. The emphasis on the interests of the large emerging countries in the current negotiations threatens to further marginalise the smaller developing countries.

The position of the smaller emerging economics and poorer countries in the international economic and financial system is thus a key element of a coherence policy for development.

The Netherlands can spotlight this issue in international forums and identify common interests and possible new coalitions. This request for advice is particularly concerned with possible changes to the international financial system, as represented by institutions like the IMF, the World Bank, the FSB, the BIS, the Paris Club and the G20. There are three core questions that we would like you to address.

1. Are the smaller emerging economics and poorer countries sufficiently represented?

How are the smaller emerging economics and poorer countries represented in the leading institutions of the international financial system? In answering this question I would ask you to focus on the following issues: what is the significance of recent decisions regarding the IMF quota system? What influence has the rise of the large developing countries had? Does it make sense to distinguish between new organs like the G20 and FSB and older financial institutions like the IMF and BIS? Can a distinction be made between formal representation and the exercise of influence?

Following on from the previous question, how can these countries' specific interests attract adequate attention, given the existing balance of power in the international system? Is their limited influence inevitable, or is there scope for better results? Options that could be considered include stronger representation of these countries in the international financial institutions, the further refinement of the G20 development agenda, the establishment of regional systems, and the concentration of the decision-making process within global institutions where these countries enjoy genuine representation.

2. What are the specific interests of this group?

The AIV could examine those specific interests of the smaller emerging economics and poorer countries which differ from those of the large countries. On that basis, do these countries need to adopt a specific position in the international financial system? How would this relate to the existing exceptional status of least developed countries, fragile states and small island states? What is the significance of the various institutions to the countries concerned? Are their interests focused on a limited number of institutions within the system? A distinction could be made between their importance for financial stability and their importance for development financing.

In answering this question I would ask you to distinguish between the various specific interests at play.

- Has the group of smaller emerging economics and poorer countries become more vulnerable on account of their increasing dependence on private financing? If so, what factors contribute to that vulnerability? Is the extent of both legal and illegal capital outflow a specific problem for them? What is the international system's importance for the financial system in the developing countries themselves? What is the influence of the economic and financial policy pursued by the large emerging countries? What impact does their role as financiers (and the conditions they set) have on the role of the international financial institutions?

- Do these countries require greater policymaking freedom, especially considering that stricter international rules and standards could limit the scope of their development policy? Can the large and wealthier developing counties be asked to make a bigger contribution, possibly in the form of graduation?

- How can the countries in question best capitalise on increasing commercial and capital flows? Should the resilience of the smaller emerging economics and poorer countries be bolstered by building capacity, strengthening good financial governance and creating an enabling environment? If so, what role could the World Bank and the regional development banks play in this regard?

3. How should Dutch coherence policy engage with the issues raised above?

What opportunities exist for Dutch involvement in this area, given the Netherlands' relatively strong position in the international financial system? What coalitions could be effective in this regard? How can we best make use of Dutch financial expertise?

I look forward to receiving your advisory report.

Yours sincerely,

Lilianne Ploumen
Minister for Foreign Trade and Development Cooperation

List of abbreviations

ACP	African, Caribbean and Pacific (group of states)
AIV	Advisory Council on International Affairs
AMRO	ASEAN+3 Macroeconomic Research Office
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
BRICS	Brazil, Russia, India, China and South Africa
CMIM	Chiang Mai Initiative for Multilateralisation
DNB	De Nederlandsche Bank
ECA	Economic Cooperation Agreement
ECOSOC	Economic and Social Council (of the UN)
EFSF	European Financial Stability Facility
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FMO	Entrepreneurial Development Bank
FSB	Financial Stability Board
GECC	Global Economic Coordination Council
GNP	Gross National Product
HIPC	Heavily Indebted Poor Country
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
NGO	Non-governmental Organisation
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
RFA	Regional Financing Arrangement
SDRs	Special Drawing Rights
UN	United Nations

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* Attended the ODI workshop on ‘Policy Coherence and International Financial Architecture’ held in London on 31 January 2014.

Background information on the international economic and financial system

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IV.1 The Bretton Woods system

During the 'golden age' of the international financial system of fixed but adjustable parities and the gold-dollar reserve standard that took effect after the end of the Second World War (the 'Bretton Woods system'), the system was commonly referred to as 'the international monetary system'. It was difficult to draw a line between the system itself and its architecture. The IMF was mandated to ensure that the exchange-rate system operated in an orderly manner, and to use a system of conditional loans to enable its members to achieve a sustainable balance of payments equilibrium without having to resort to emergency measures, such as protectionism and excessive currency devaluation, that would be detrimental to global prosperity.

The executive bodies responsible for implementing this mandate were the management and the Executive Board, an in-house supervisory body composed of representatives of the member states whose meetings were chaired by the Managing Director, as well as a Board of Governors, consisting of the responsible minister or the central bank governor of each member state. The Board of Governors met once a year during the annual meeting and delegated virtually all its powers to the Executive Board.

As described in its articles of agreement, the World Bank's object was to use loans to help fund the recovery of the severely war-torn economies and to foster the development of underdeveloped shareholder countries. Its management structure was similar to that of the IMF. In 1960, the World Bank launched a subsidiary for making highly concessional loans to poorer developing countries, i.e. those beneath a given income threshold. This subsidiary, which was known as the International Development Association (IDA), was funded with donations whose value was fixed during triennial 'replenishment negotiations' among the donor countries. The resources pledged during these talks were used to make loans with a large gift component, subject to terms set by the donor countries during their negotiations. This enabled the IDA to adopt a different focus in its lending as compared with standard World Bank loans.

The authority of the two institutions stemmed from supranational legislation and the formal equal treatment of all member states (in the case of the IMF) and shareholder states (in the case of the World Bank). In both cases, all members or shareholders were

represented either directly or indirectly on their boards (Executive Board). The biggest countries each had their own executive director, while the smaller countries formed constituencies so as to meet the quota set for a seat on the Board. With the increase in the number of independent countries, mainly the result of the decolonisation process, the Boards have grown in size from 12 to 24 seats.

In tandem with the Organisation for European Economic Cooperation (the precursor of the OECD), the main focus during the early stages was on restoring smooth payment services and guaranteeing the free convertibility of currencies for transactions in progress, leading to the promotion of free trade as a necessary condition for optimum specialisation and growth. Thanks to the efforts of the OECD in particular, attention soon turned to opening the road to foreign direct investments (FDI), which were also regarded as being conducive to greater prosperity and development. At the end of the 1960s, the IMF created a strictly fiduciary artificial reserve asset known as the SDR for members to use. The idea was to relieve pressure on the US dollar, and eventually for SDRs to replace the dollar entirely. However, due to the developments described below and the reluctance of the US authorities to relinquish the dollar's role, SDRs never really took off in the way that had been hoped.

Little by little, the scale of capital flows started to swell. At the outset, movements of capital were concentrated among the industrialised countries. There was a clear logic to this: the growth in prosperity was translated into an increase in wealth, both in absolute terms and relative to GNP, and the titles to this wealth became increasingly marketable. Those parts of the world that are now developing relatively quickly, i.e. the emerging economies, took part in this process, thanks to the rapid expansion of their own financial sectors. Portfolio flows and short-term capital flows gradually began to account for a larger proportion of overall capital flows. This was one of the factors involved in the decision to abandon the system of the fixed gold-dollar price and fixed but adjustable parities.[65] In fact, the virtually uncontrollable nature of capital flows had made floating exchange rates inevitable. Systematic reserve creation was no longer a priority for the system.

Although the IMF retained its role as a watchdog supervising the orderliness of exchange-rate movements, it lost some of its influence as the main member states no longer felt obliged to borrow reserves on conditions that generally boiled down to a set of restrictions on the way in which the money could be spent. Smaller member states and those member states which had yet to secure a clear status nonetheless clung to either a globally dominant currency (i.e. the US dollar) or a locally dominant currency, such as the Deutschmark. These countries continued to fall back on IMF loans whenever either an external cause or domestic mismanagement led to severe balance of payments imbalances. The Asian crisis in the late 1990s, which hit the emerging markets particularly hard, was a good example. The treatment was harsh – and in the eyes of many (especially those in the affected countries) needlessly so – and was based in part on the view, widely held at the time, that countries should not impose restrictions on capital movements.[66]

65 Other contributory factors were the intractable Triffin dilemma of the gold cover for the reserve currency and disagreement as to which countries should adjust: the deficit country holding the reserve currency, the US or the surplus countries.

66 Malaysia refused to obey the dogma and imposed restrictions on capital outflows.

The low-income countries had also swallowed the IMF's bitter pills – albeit over a much longer period of time – in the form of Structural Adjustment Programmes. This is not the appropriate place for analysing the composition of the pill. However, the consequence of treatment was that many countries, just like the emerging markets, did their utmost to avoid having recourse to the IMF. This they did by using an undervalued currency to build up their official reserves, which they then invested in US treasury paper. This is sometimes regarded as the macroeconomic cause of the persistently low interest rates in the West in the 1990s and as one of the factors behind the property and mortgage bubble, notably in the US. When this bubble finally burst in 2008, it heralded the start of the financial crisis. In the meantime, both academic researchers and the IMF itself ceased to regard the imposition of restrictions, particularly on incoming capital, as a policy tool that was by definition inappropriate.[67]

In the wake of criticism of the detailed conditions imposed by the IMF, the IMF itself also began to accept the need to concentrate on the main issues and not to concern itself needlessly with the choice of sectors in which unavoidable spending cuts would have to be made. One of the considerations here was a recognition that an international financial institution would undermine its own authority if it was too quick to meddle in political decisions. The institutions tried to steer well clear of issues of national wealth distribution, one of the most politically sensitive subjects. Interestingly, both the World Bank and the IMF's Research Department are now studying this, given that studies of the relationship between inequality and economic growth and efficiency have conclusively shown that extreme inequality undermines economic growth.[68]

IV.2 Voting rights in the IMF and the World Bank: the voice of low-income countries

The IMF and the World Bank each have two sub-Saharan African seats on their executive boards, roughly comprising one Anglophone and one Francophone seat, with Portuguese-speaking countries included in the former group. Each seat represents 21 countries. Their shares of IMF voting rights are 3.3% and 1.6% respectively.[69] The African seats rotate the post of executive and deputy executive director (there are now two of the latter for large constituencies, due to the workload), as well as lower-ranking support posts (whose number has also been increased). The remaining low-income countries are members of other constituencies, i.e. mixed constituencies consisting of Western countries and 'higher' middle-income countries and developing countries.

With two seats for sub-Saharan countries, the quotas have been slightly adjusted as a factor in their representation on the Board, in order to achieve a regional balance and an acceptable number of members per seat. South Africa and Nigeria (both middle-

67 A balanced, case-by-case approach is needed. Prolonged, drastic restrictions require an expensive supervisory mechanism and lead to evasion. However, temporarily discouraging 'hot money' with the aid of negative rates of credit interest and high cash reserves can bring some useful relief.

68 See Finance and Development, September 2011.

69 The shares of the Board's voting rights are based on the quota share, with all countries holding a fixed number of basic votes. The quotas are calculated on the basis of a country's share of the world economy (based on GNP at market prices as well as purchasing power parities, openness to trade, variability of current balance-of-payments results and size of international reserves). The formula is adjusted from time to time.

income countries) hold dominant quotas in the Anglophone constituency, although this does not give them a unilateral right to an executive director's post. For some time now, complaints have been made about the unrepresentative nature of the current distribution of seats, and many calls have been made for a sharp reduction in the number of European seats. There are good reasons for such a step. Although a reduction in the number of European seats would not benefit the low-income countries in terms of their relative voting rights, it would mean a sharp increase in the relative representation of Africa.

Although the reforms of the quota system agreed by the member states in 2010 as part of the 14th general review of quotas should already have taken effect at the end of 2012, they are still awaiting US Senate approval. The aim of the reforms is to enhance the effectiveness of the Board and to improve the IMF's representativeness and legitimacy. The reforms are as follows:

- a doubling of total quotas;
- a shift of more than 6% of quota shares to emerging market and developing countries, while protecting the status of the poorest members (there will be a rise of more than 5% in this group's voting rights); and
- the abolition of the system of designated Board seats (allotted to the five largest members, i.e. the US, Japan, Germany, the UK and France): all executive directors must be elected. This does not mean that the countries in question (and three other large countries) will no longer have a seat of their own, but that they may share their seat with other countries if they wish.

Although the latter aspect paves the way for European consolidation and hence for a reduction in the number of Board members, it remains to be seen whether this will actually materialise in the near future. At the least, both Germany and France will need to be willing to give up their seats as eurozone members.

Although the World Bank generally follows in the IMF's footsteps by proposing an increase in capital shares in the wake of a general review of quotas, it has not decided to propose a doubling of its capital. This might make it more difficult to achieve a 6% shift than at the IMF. Also, the World Bank has not reiterated the IMF's argument in favour of eurozone consolidation, i.e. that the eurozone is now pursuing a single monetary and exchange-rate policy centring on the euro. Although there is some bilateral coordination of development cooperation, including with the EU, the EU is a long way from adopting a common position on the role of the World Bank group.

One of the complaints levelled against the IMF and the World Bank is that the appointment of their respective Managing Director and President is not democratic and based on the abilities of the available candidates. In practice, it would appear that the original arrangement between the US and Europe that the President of the World Bank should be an American and the IMF's Managing Director should be a European, continues to hold strong. This is despite the fact that both institutions produce job profiles that are approved by the Board, that candidates apply for the posts and that elections are held. The US and Europe have consistently backed each other's candidate for the post to which they themselves are not 'entitled'. While such action may be regarded as a politicisation of the appointment process, some form of politicisation would appear to be unavoidable and will produce different results (and not different processes) only if there is a change in the balance of political power and in global alliances.

IV.3 IMF and World Bank post-crisis support for low-income countries

The IMF described the situation in 2009 as the third wave of the financial crisis. Together with the sharp increase in food and fuel prices, it had a powerful impact on the low-income countries and posed a threat to the great progress they had made in the previous decade. The IMF noted that there had been a substantial rise in the demand for loans. Its response was as follows:

- in sub-Saharan Africa, new lending commitments to low-income countries for the first half of 2009 reached USD 2.7 billion compared with USD 1.1 billion for the whole of 2008;
- plans to increase lending in 2009 and 2010 to up to USD 8 billion (thereby exceeding the G20 call for additional lending of USD 6 billion), funded in part by gold sales;
- debt relief on all interest payments due to the IMF until 2012, and higher concessionality on future loans;
- a new architecture of concessional financing facilities, consisting of three new instruments that will be more flexible and tailored to low-income countries: (i) a Standby Credit Facility for short-term and precautionary needs, (ii) an Extended Credit Facility for medium-term support, and (iii) a Rapid Credit Facility, which offers emergency support with limited conditionality;
- streamlining of conditionality, particularly for structural reforms;
- guarantees in lending programmes for social and other forms of high-priority spending and higher levels of pro-poor spending.

Although the response of the World Bank group was ostensibly less radical, its IDA subsidiary was already largely geared to the long-term borrowing requirements of low-income countries. Most IDA countries were hardly affected by the crisis, since their domestic financial sectors were not closely integrated with global markets. At the same time, these countries did feel the indirect effects, in the form of a dropping-off of FDI, lower remittances, less tourism, a deterioration in the terms of trade and more sluggish export growth, plus for certain countries a reduction in the volume of bilateral development aid. The World Bank claimed to be well resourced: this applied both to the bank itself and to the IDA, under the IDA 15 Replenishment.[70] The bank was able to undertake new commitments worth USD 100 billion over a three-year period, with a tripling of commitments in the current year, while the IDA had USD 42 billion available for lending to the poorest countries in the same period.

The IFC, the World Bank group's corporate lender, created a number of new facilities for bank recapitalisation, infrastructure finance and trade finance. The combined value of the IFC's new facilities is said to be over USD 30 billion per annum.

IV.4 The role of the UN in the international financial architecture

Under the auspices of ECOSOC, a large number of developing countries are gathered at the UN under the heading of 'least developed countries' (LDCs). The LDC secretariat was originally based at UNCTAD, which was also responsible for implementing the programme of action. In 2001, the secretariat was transferred, at the LDCs' request, to the UN's ECOSOC in New York. This group of countries is characterised by an income limit similar to that applying to the low-income countries, a low human development index and structural challenges such as a geographically isolated location.

70 IDA 15 ran to 2012. IDA 16 is currently in force (for 2013-2015).

The LDC group regularly calls for action to be taken to meet their needs and aspirations. For example, in their 2011 Programme of Action, the LDCs called for an 'inclusive' representation in the international economic system and for their special development needs to be addressed. A broader recognition of LDC needs would, they claimed, help to integrate the programme of action with development policy. In the Istanbul Programme of Action, the LDCs pressed for 'voice' to become a guiding principle of the international financial architecture: '*Voice and representation: the international economic system and architecture should be inclusive and responsive to the special development needs of least developed countries, ensuring their effective participation, voice and representation at all levels […].As long-term partners in the development process of least developed countries, the organizations of the United Nations system, including the Bretton Wood institutions, have a special role to play in the implementation of the Programme of Action*.'[71]

The phrase used in the Programme of Action, i.e. 'the United Nations system, including the Bretton Woods institutions', is a reference to the fact that the international financial institutions fall under the aegis of the UN and, in the eyes of some observers, should be accountable to ECOSOC, which is more representative of the poorest and smaller countries thanks to the 'one country, one vote' mechanism. There is also a desire to make the international financial institutions more accountable in terms of respect for international human rights.

IV.5 The Basel Committee on Banking Supervision, the FATF and other institutions

This institution shares the aim of enhancing financial stability, but seeks to achieve it by improving the quality of banking supervision around the world. The Committee was set up in 1974 in response to a small number of bank collapses which were themselves triggered by the disruption caused by the abandonment of the gold-dollar standard in 1973. During the intervening period, the Committee's role in the international financial architecture has only grown in importance, mainly thanks to its analysis of the causes of the 2008 financial crisis and the realisation that big international banks such as Lehman Brothers have become 'too big to fail'.

The Committee was founded by the central banks of the G10 group of richest countries as a consultative platform. Its secretariat is housed at the Bank for International Settlements in Basel. The reports and guidelines published by the Committee do not have any legal status. Membership has grown over the years to 27 countries, which are represented by their national bank supervisors, generally the central bank.

The Committee formulates standards and guidelines for supervision, recommends best practices and supervises implementation. While coherence is one of its objectives, it does not seek to achieve full harmonisation. It invites contributions from representatives of the banking industry. One of its departments, known as the Supervision and Implementation Group, deals with implementation issues in both member states and non-member states.

71 Fourth United Nations Conference on the Least Developed Countries (2011), 'Istanbul Declaration', Istanbul, 9-13 May 2011; and 'Programme of Action for the Least Developed Countries for the Decade 2011-2020', Istanbul, 9-13 May 2011.

One of its first achievements, in 1975, was an agreement on the joint supervision of foreign bank branches by the regulatory authorities in both the country of the bank's head office and the country of establishment of the foreign branch in question, using a system of information sharing. A paper entitled *Core Principles for Effective Banking Supervision* was published in 1997; this was compiled in conjunction with and was geared specifically to non-G10 countries (including emerging economies) as well as G10 countries. This document, which is reviewed on an ongoing basis, most recently in September 2012, sets out 29 core principles.

The first Basel Capital Accord (known as Basel I), containing guidelines for minimum capitalisation requirements for banks, was published in 1988. This was at a time of growth in both international banking activities and the associated risks to which banks were exposed. It was also a period in which there was a danger of unfair competition among countries resulting from decisions taken by individual governments to lower their national capitalisation requirements. Basel I stipulated that a bank's equity capital should represent at least 8% of all its risk-weighted assets by 1992. The standard was eventually adopted by all countries with banks operating on international markets. The risk that banks were required to weight was credit risk.

A major addition to Basel I followed in 1996. This was the principle of not just measuring and weighting the credit risk associated with banking activities, but also other 'market risks' such as currency risks and the risks resulting from fluctuations in the value of traded goods and securities.

Basel I was succeeded by Basel II in 1999, with an update following in 2004. Basel II is based on three pillars of banking supervision, i.e. capital requirements, regular internal and external capital reviews, and mandatory reporting. A consensus document on banks' trading books was incorporated in Basel II in 2006; this contained guidelines for the valuation of tradable goods and securities.

During the years preceding the financial crisis, a number of worsening problems were recognised:
- excessively high levels of leverage;
- excessively low levels of liquidity;
- inadequate governance and risk management;
- perverse incentives.

Together, these resulted in the mispricing of credit and liquidity, and excessive lending.

Basel III was adopted in 2010, i.e. after the crisis, by the G20. It strengthened the three pillars of Basel II, adding a number of new elements such as:
- restrictions on the payment of dividend by banks without enough capital;
- the maintenance of a counter-cyclical capital reserve preventing banks from swimming too much with the flow during a boom;
- the imposition of extra tough requirements on 'systemic banks', i.e. banks deemed too big to fail whose collapse would threaten the future of the system as a whole; these big banks are currently concerned about the effects of these requirements and some are in the process of downsizing; and
- an absolute capital requirement based on the nominal (i.e. unweighted) asset value.

Agreement was also reached on a mechanism for supervising the implementation of these requirements, to be introduced in stages during the period from 2013 to 2017.

The Basel Committee has made sure that Basel III is consistent with the wishes of the recently founded FSB as set out in the latter's Coordination Framework for Monitoring the Implementation of Financial Reforms. The agreement introduced a fundamentally new aspect of banking supervision, i.e. macroeconomic factors. It is no longer a question of looking exclusively at the health of individual banks. Rather, the scope of supervision has been extended to cover the financial system as a whole.

In addition to the Basel Committee on Banking Supervision, the Financial Action Task Force (FATF) is another organisation that merits discussion. The FATF was founded at a G7 summit in 1989. It is based in Paris, at the offices of the OECD. The FATF's object is to prevent money laundering by designing suitable laws and measures and encouraging both members and non-members to adopt them. The FATF's remit was extended in the wake of 9/11 to include anti-terrorism. The FATF's members comprise the OECD, the European Commission, the Gulf Cooperation Council, Argentina, Brazil, Russia, Singapore, Hong Kong and China. There are also a number of regional associations of non-members, including three in Africa. For many years, the FATF held a blacklist of jurisdictions regarded as not being sufficiently cooperative. The blacklist had such a powerful effect in persuading other countries not to lend to listed countries that the list was eventually discontinued – an effective example of peer group pressure. Decisions are taken by consensus and have led in practice to the adoption of national legislation by the member states and the EU (in the case of the Netherlands, the Money Laundering and Terrorist Financing (Prevention) Act 2008). The FATF is of particular value to those low-income countries that are relatively closely integrated into the world economy. Its stamp of approval can help to gain the trust of lenders.

Other institutions worthy of mention are:

- the Bank for International Settlements (BIS) in Basel. It is the oldest international financial institution, and was founded in 1930 as the 'bank for central banks'. Sixty central banks are currently members of the BIS. Apart from arranging payments among these central banks, the BIS is also known for its role in facilitating the Basel Committee on Banking Supervision;
- the International Organization of Securities Commissions, an international consultative body for all the national securities regulators;
- on account of the US dollar's pivotal role in the world economy: the Securities and Exchange Commission, the Federal Reserve Bank and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which was enacted in response to the crisis and which imposes extremely strict regulations on the financial sector, partly to promote financial stability; financial institutions that are active on international markets, including those based in developing markets, are obliged to adhere to the terms of the Dodd-Frank Act;
- on account of the economic significance of Europe and the eurozone: the European Banking Authority, the European Securities and Markets Authority (whose tasks include monitoring credit-rating agencies), the European Insurance and Occupational Pensions Authority, and the European Central Bank.[72]

The financial crisis exposed certain weaknesses in the structure and enforcement of the supervision of national financial institutions in the EU. In January 2011, in order to boost financial stability and restore public confidence in the financial system, the

72 See also: AIV advisory letter no. 19, 'Towards Enhanced Economic and Financial Governance in the EU', The Hague, February 2012.

EU adopted a new supervisory mechanism known as the European Financial Stability Facility (EFSF). The EFSF consists of the following bodies: the European Systemic Risk Board for macro-prudential supervision and three sectoral supervisory bodies for micro-prudential supervision, i.e. the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Markets and Securities Authority. The first of these bodies, the European Systemic Risk Board, focuses on the robustness of the financial system as a whole and works with other bodies such as the IMF, the FSB and the Basel Committee on Banking Supervision. The system of banking supervision will be further strengthened by the EU banking union or the Single Supervisory Mechanism, under which micro-prudential supervision of the systemic banks in the eurozone is to be transferred from national regulators (such as, in the case of the Netherlands, DNB and the Netherlands Authority for the Financial Markets) to the European Central Bank in the course of 2014. The EU is also preparing a European Deposit Guarantee Scheme to protect savings deposits, and a European Resolution Mechanism for dealing with troubled banks.

IV.6 Currency unions

A review of the international financial system would not be complete without mentioning groups of countries that have joined forces to create a single currency in order to achieve financial stability. In 1945, the CFA franc was created for the French colonies in Africa, along with a small number of Spanish and Portuguese colonies. The CFA franc was pegged to the French franc, although the fixed exchange rate was adjusted on a couple of occasions. According to some, the stability of this currency union boosted trade and economic growth. At the same time, it displayed some of the drawbacks inherent to a currency union, notably the fact that countries with divergent economic conditions do not have a means of reducing mutual imbalances.

Although the formation of a currency union appears to be an attractive way of offering relatively small countries, including low-income countries, greater financial stability and financial clout, experts believe that it requires such close cooperation as to preclude it as a viable option for the time being. They point both to the problems encountered by European countries with the euro and to the advantages of variable exchange rates.

IV.7 Private capital flows to developing countries

International private capital flows to developing countries and emerging economies have risen sharply during the past two decades and have played a significant role in the emergence of a number of middle-income countries.

The aggregate net flow of capital to developing countries and emerging economies rose from USD 300 billion to USD 1,400 billion between 2002 and 2007.[73] The flows are the result of supply and demand, with the level of supply depending on a number of global push factors and the level of demand depending on national pull factors. International capital flows have been bolstered by the liberalisation of international capital movements, improved and more stable monetary and macroeconomic policies pursued by certain countries, and the emergence of worldwide investors such as investment banks, pension funds, insurance companies, hedge funds and venture capital funds.

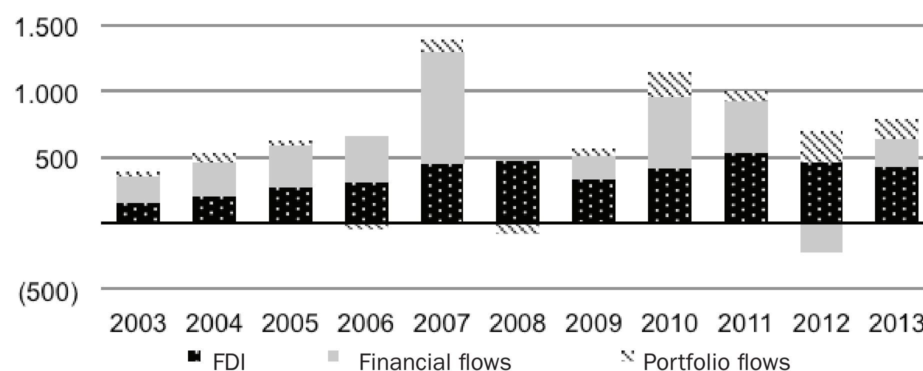
73 See various issues of the World Economic Outlook (IMF).

There are three types of capital flows:
1. foreign direct investment (FDI);
2. loans from banks and international financial institutions, also known as debt flows;
3. securities transactions, such as short-term trading in equities and corporate and government bonds, including trading in derivatives.

Trade finance is not regarded as constituting an international capital flow. The amount of trade finance may be derived from the difference between the trade balance based on accrual accounting and that based on cash accounting.

The inflow of capital to developing countries (including middle-income countries) has shown the following pattern during the past 10 years:
- an increase since 2000, which was brought to an abrupt end by the crisis in 2008;
- contraction in 2007-2009, at a time when costs were rising due to the (perceived) higher risk; and
- a revival in capital flows after 2009, although these were volatile, due to panic reactions to the eurozone crisis and the policy of monetary easing in the US.

Net private capital flows to all developing countries (2003-2013, in USD billions)



Source: Policy Coherence and the International Financial Architecture (ODI, 2014, p. 3).

FDI and financial flows rose gradually until 2007. The value of portfolio flows was relatively insignificant. FDI remained reasonably stable during the crisis, peaking at USD 472 billion in 2008. It declined during the years thereafter, as the pattern of FDI flows became more variable.

The same applies to an even greater extent to portfolio flows. While they were limited during the pre-crisis years, securities trading expanded in 2010 and 2011 as a result of supply-side factors. Yields in the West were under pressure at the time due to quantitative easing (a crisis management measure in the US), which was coupled with extremely low interest rates, thus driving investors (including those in the shadow banking systems, i.e. non-regulated institutions) to look for higher returns elsewhere. Portfolio flows dipped for a brief period on reports that the US administration was planning to dial back quantitative easing.

The figures for the period starting in 2009 show wide fluctuations in capital flows, caused primarily by financial and portfolio flows to and from a small number of middle-income countries such as Brazil, India, Turkey and Indonesia. These economies may have been overstimulated, on account of more foreign capital coming into the country than could be put to productive use. Part of the incoming capital was short-term capital in search of a quick return.

Capital flows to low-income countries

The above picture hides the fact that there were major differences between individual countries, including within the group of developing countries. There is a clear divide between the middle-income countries and the 36 poorest countries, also known as low-income countries. The former account for the lion's share of net private capital flows: 97% of net inflows goes to the middle-income countries, whereas just 3% is destined for the low-income countries.[74] By way of comparison: the combined GNP of the low-income countries made up 15% of the GNP of all developing countries in 2012. In other words, a significantly lower volume of capital goes to the low-income countries, in both absolute and relative terms. Despite being low in value, private capital flows to low-income countries have been growing consistently in recent years. Moreover, a low level of capital inflow is not by definition a bad thing.

Annexe IV.12 contains a table with selected data for the 36 low-income countries that could be used for making a more detailed analysis of the factors on which capital flows depend. The following points are of interest in this connection:

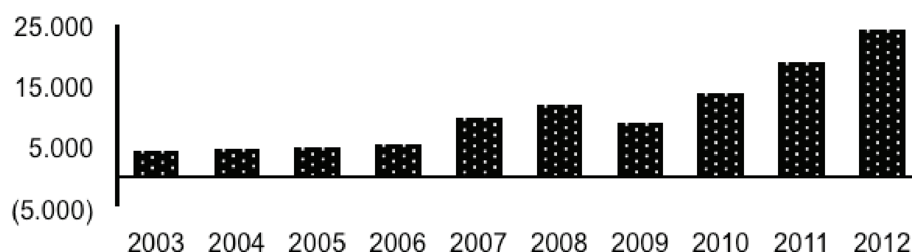
- 28 of the 36 countries are 'fragile' (i.e. extremely vulnerable), as defined by the OECD/DAC;
- only seven countries have stock exchanges; the average capitalisation of these exchanges is 18% of GNP, as opposed to an average of 70% in rich countries;
- average total banking assets represent 15% of GDP, as opposed to 99% in rich countries – an indication of the limited volume of banking services;
- the average size of pension funds is 1% of GDP, as opposed to 26% in rich countries;
- all 36 countries score and are ranked either low or very low on indicators for governance, ease of doing business and corruption perspective, with one notable exception: Rwanda.

Private capital flows to low-income countries fall into the same three categories as described above, with financial flows forming by far the largest component. Financial flows have shown a predominantly rising trend during the past 10 years, increasing from 20% of GNP in 2003 to just over 30% in 2012.[75] Significantly smaller in scale but no less important is foreign direct investment. This, too, shows a rising trend, growing from 3% of GNP in 2003 to over 5% in 2012. In absolute terms, there has been a fivefold rise in FDI within the space of 10 years:

74 This is the official name for the group of 36 poorest countries, 28 of which are located in sub-Saharan Africa.

75 This is a somewhat arbitrary but commonly used indicator. Percentages indicate the relative size of a capital flow, not its share of the GNP of a country or group of countries. The latter depends partly on how the capital is used.

Net FDI inflows to low-income countries (2003-2013, in USD millions)



Source: Policy Coherence and the International Financial Architecture (ODI, 2014, p. 8).

Average figures are misleading, including in the group of low-income countries. Some countries are much more popular among foreign investors than others. In Bangladesh, Cambodia and Mozambique, for example, FDI represented between half and three-quarters of GNP in 2012. This is in stark contrast with the 10 countries in which FDI represented less than 1% of GNP, i.e. South Sudan, Burundi, Guinea-Bissau, Burkina Faso, Central African Republic, Afghanistan, Comoros, Togo, Malawi and Somalia.

Newcomers and frontier funds

There was an interesting trend in portfolio flows, which used traditionally to be very low in low-income countries (where the average for the past 10 years did not exceed 0.4% of GNP). There was a dramatic change in 2013, when a number of countries, including Tanzania, Kenya, Rwanda, Mozambique and Uganda, all received the go-ahead from the IMF to issue their very first government bonds on the international capital market; the total value of these issues was USD 1.7 billion. Bangladesh is on the point of following suit.

It is unclear, however, whether this new step will give the countries in question lasting access to the international capital market. One of the main reasons why the IMF gave its approval was the leverage effect of ODA, i.e. the principle that ODA could be seen as a form of equity enabling the country in question to raise a certain amount in loan capital. This means that any repetition or continuation of such international bond issues is dependent on ODA. Moreover, for the time being, these issues are too small to enable a market to be formed on which they can be actively traded. This is a prerequisite, however, if they are to be attractive to large private investors, who want to be able to sell their holdings at any time.

Other criticisms can also be levelled at these government bond issues.[76] Even though it may look as though a country can save money by replacing high-interest domestic debt with low-interest foreign debt, the process of issuing bonds remains more expensive than that of raising 'soft' loans (i.e. loans with a relatively long maturity and carrying

76 See *inter alia*: Hou et al. (2014); J. Stiglitz and H. Rashid (2013), 'Sub-Saharan Africa's Eurobond borrowing spree gathers pace. Why are an increasing number of developing countries resorting to expensive sovereign-bond issues?', *The Guardian*, 26 June 2013, see: <http://www.guardian.co.uk/business/economics-blog/2013/jun/26/subsaharan-africa-eurobond-borrowing-debt>; and S. Griffith-Jones (2013) 'The case for prudent financial liberalization and its policy implications', Berlin Finance and Development Conference.

a relatively low rate of interest) from foreign donors (including international financial institutions) for financing development or exports. Moreover, the bonds are denominated in US dollars, which exposes the issuing governments to currency risks.

The main reason why investors take an interest in these bonds is not so much a feeling of confidence in the strength of the issuing country's economy, but rather the prevailing mood among investors and the low yields around the world, i.e. push factors. These 'frontier funds' (as foreign investments in public-sector and private-sector securities issued by newcomers are termed) are capable of triggering powerful movements on capital markets in a given region, as is illustrated by the sharp rises in equity prices seen in Tanzania (+25%), Kenya (+44%), Malawi (+62%) and Uganda (+33%) in 2012 and 2013.

IV.8 A sustainable level of debt

The key issue in relation to these bond issues, and in fact in relation to all forms of capital raised from foreign sources, is whether they help in bringing about a sustainable level of debt for the country in question. This, in turn, depends on whether the capital is used for productive purposes. The balance between a shortage of capital and too much of a good thing is a delicate one.

Although foreign capital can give a vital boost to economic growth, it is a source of threats as well as opportunities. By economic standards, low-income countries have a relatively large investment need and a low savings ratio. Moreover, there is a mismatch between short-term savings deposits and the long-term investment capital that is required for financing infrastructural projects or for meeting the needs of small and medium-sized businesses, for example. As a result, additional capital obtained from foreign sources is welcome.[77] This is also one of the factors in any decision to award ODA. However, private foreign capital creates future obligations.

In order to achieve a sustainable level of debt, the capital should be used in a manner that generates a return that is at least sufficient to enable the borrower to discharge its obligations. If it is not, for example if the foreign capital is used for consumption purposes or for funding projects driven by prestige or social objectives rather than financial return, the result may be an unsustainable level of debt.

A number of experts believe that there is a level beyond which foreign capital no longer fosters economic growth. Indeed, such capital may even be counterproductive, for example if it brings upward pressure to bear on the exchange rate and hence hampers the country's exports (this is known as the risk of 'Dutch disease'). This is clearly borne out by the volatility and boom-and-bust cycles discussed above, whose net effect on an economy is not favourable.

The pace and size of capital inflows should not be greater than the pace and size of the additional productive investments such capital is capable of financing. Governments and businesses that raise capital will need to make their own assessment of the likely

77 According to the African Development Bank, there is a USD 31 billion funding gap for infrastructure in Africa. Of this figure, USD 23 billion relates to energy, while USD 11 billion relates to water and sanitation. The funding gap represents 9% of GNP in non-fragile low-income countries and 25% in fragile states (AfDB 2011).

return. Overoptimism may ultimately cause problems.[78] However, suppliers of capital also have a responsibility of their own and what some observers regard as a 'duty of care'. They also have their own interests to safeguard: poor lending policies may result in them being compelled to contribute to debt restructuring programmes agreed by the Paris Club.

Apart from the questions of pace and size, it is also important to ensure that inflows and investments are properly matched in terms of duration and currency. Investments in infrastructure and social sectors such as education and health care, for example, do not have an impact on economic productivity until some considerable time has passed, which means that they need to be financed with long-term capital. Moreover, the long-term return they generate is not necessarily in the form of higher export revenues and hence foreign currency earnings.

The experts consulted for the purpose of this study felt that there were no problems on the supply side: there is a sufficient supply of international capital looking for safe, profitable investment opportunities. Certain low-income countries are even witnessing a net outflow of national capital ('capital flight'), the potential reasons for which are an absence of markets and investment opportunities, tax motives or the risk of mismanagement. At the same time, certain commentators may be right in claiming that the risks pertaining to low-income countries are perceived as being higher than they actually are.[79] Credit-rating agencies may perform an insufficiently thorough analysis of the investment risks associated with low-income countries.

Trade finance has been calculated by a number of commentators as accounting for up to 80% of a number of developing countries' debts.[80] Under the Basel rules on bank supervision, it was relatively easy to grant trade finance, as the goods being traded could often be used as collateral. The new Basel capital ratio requirements may restrict the scope for trade finance, and this could affect low-income countries. Certain imports are financed by the exporters in question, some of whom are able to offer concessional loans on behalf of their governments, which are keen to promote their country's exports.

IV.9 Some figures on ODA and remittances to low-income countries

The flow of incoming capital in low-income countries does not consist solely of private investments. It also includes aid from public-sector donors (which in many cases accounts for the bulk of the incoming capital). In recent years, the flow of this type of aid into this group of countries has risen in absolute terms from USD 21 billion in 2003 to USD 43 billion in 2011. Because these countries' economies grew even faster during the same

78 A deep-rooted problem with capital flows is that, partly due to lower interest rates, projected returns are higher during an economic boom. This explains the pro-cyclical behaviour of capital.

79 Paul Collier, for example, believes that the financing of infrastructure in Africa is hampered by a tendency to overrate the risks involved. See: 'Unlocking Private Finance For African Infrastructure', *Social Europe Journal*, 12 November 2013.

80 80% of the debt has arisen from transactions based on Economic Cooperation Agreements (ECAs) between the EU and its ACP partner countries. See: Øygunn Sundsbø Brynildsen, 'Exporting goods or exporting debts? Export Credit Agencies and the roots of developing country debt', Eurodad Report, December 2011.

period, there was a gradual decline in the value of aid as a proportion of the aggregate GNP from 12.5% in 2003 to 10% in 2012. Big aid recipients are Afghanistan (USD 6.7 billion in 2011), the Democratic Republic of the Congo (USD 5.5 billion), Ethiopia (USD 3.5 billion), Kenya and Uganda (USD 2.4 billion each) and Haiti (USD 1.7 billion).

Remittances, i.e. payments from friends or relatives working abroad, are also a major source of income. In December 2013, the Pew Research Center published a report showing that remittances to low-income countries represented between 5% and 8% of their GNP during the period between 2003 and 2012.[81] Here too, there are wide disparities between individual countries. Bangladesh heads the list with USD 15 billion worth of remittances in 2013. Nepal and Tajikistan received USD 5.4 billion and USD 4.1 billion in remittances respectively. This means that the inflow of remittances in these three countries was five to six times higher than the combined value of their inflows of ODA and FDI.

The picture is different in countries such as Kenya and Uganda. Although remittances continue to form a major source of revenue (accounting for USD 1.3 billion and USD 1 billion respectively in 2013), the inflow is less significant as compared with ODA and FDI, accounting for around half in Kenya and a quarter in Uganda. Although remittances are less high in other low-income countries, they still constitute an important form of income.

ODA and remittances are linked only indirectly to the international financial architecture. The potential interactions between them include the disruptive effect that ODA and remittances might have on international capital flows, the international financial institutions' own contributions to ODA, and the influence exerted by these institutions on ODA from other donors.

Remittances require the presence of a reliable and unrestricted system of international payments and are sometimes affected by national tax laws.

IV.10 Capital flight

Illicit capital exports are an acute problem for low-income countries, particularly for those countries that are rich in raw materials (including drugs). One of the main causes of the problem is capital acquired by illegal means within a country's economy. In theory, the international financial architecture has no bearing on this money. International transfers of this type of capital are not by definition illegal. The fact that people attempt to make such transfers furtively is often due to the desire to conceal the source and ownership of the money and not to the illicit nature of the transfer. There may be certain reasons why such transfers *are* illegal, in which case there is a link with the international financial architecture. These reasons include restrictions on capital movements and international agreements reached within the FATF on preventing money laundering.

Although it is difficult to get hold of accurate figures, estimates suggest that huge sums of money are involved. It has been calculated, for example, that USD 816 billion vanished abroad from sub-Saharan African countries during the period between 1970

81 See: P. Conner, D. Cohn, A. Gonzalez-Barrerra and R. Oates, 'Changing Patterns of Global Migration and Remittances', Pew Research Center, 17 December 2013.

and 2010.[82] This is almost the same as the combined value of development aid and FDI received in the same period, i.e. USD 659 and 306 billion respectively. Sierra Leone heads the group of low-income countries in this respect, with capital worth five times its GNP disappearing abroad during this period. This is equivalent to an average of 12.5% of the country's GNP per annum. Large sums of money also left Mozambique and Burundi, i.e. between 2.5 and 3 times the size of their GNP, during this period.

Reports indicate that the value of foreign capital holdings now exceeds the continent's aggregate level of debt. However, foreign capital holdings are generally privately owned, whereas debts are incurred by governments, which means they are borne by the population as a whole.

IV.11 The impact of volatility on the real economy

Most of the international capital created by quantitative easing (i.e. the policy of injecting money into an economy) accrues to banks, pension funds, companies and private funds. The extremely low interest rates in the US and the EU have pushed capital in search of higher returns. Investments funds such as hedge funds (which are not covered by the Basel supervisory regime) invest the money entrusted to them in, among other things, government bonds issued by developing countries which have good prospects, but which are compelled to offer a high rate of interest because the market does not have enough confidence in them. Investment funds may also buy local equities in countries that have a domestic stock market with sufficient liquidity (i.e. a high enough volume of trading). These are known as 'frontier funds', i.e. funds for adventurous money in search of a higher return.

Higher demand for government paper will push up its value, push down the effective rate of interest for the issuing authority and create more scope for borrowing. This will stimulate the propensity for consumption, a trend that politicians find very difficult to reverse (this applies equally to rich countries). The government deficit will rise. In countries with weak governance, there is a risk of asset misallocation and an unsustainable level of debt if foreign capital is used to finance less productive investments.

The pattern is similar in the private sector. Although many frontier funds have a short investment horizon and do not invest directly in infrastructure or business assets, for example, an indirect stimulating effect may nonetheless occur in the private sector. As the value of equities, bonds and any assets that generate cash flows tends to rise, so banks can lend more because their collateral is now worth more (in accordance with the Basel capital requirements). Moreover, the lower the level of interest rates, the more attractive investment projects appear. Although this may be a welcome trend, it may also lead to the formation of a bubble, depending on the use made of the capital and the type of loans granted.

In short, the inflow of frontier funds may act as a powerful spending stimulus for both the public and private sectors of the economy. A degree of discipline is required to ensure that productive use is made of the extra funds. The additional demand for the local currency may push up the rate of exchange, making local exports less competitive.

82 See: Boyce and Ndikumana (2012) and Attiya and Waris (2011), 'Bringing the billions back: How Africa and Europe can end illicit capital flight'.

The result may be a double deficit, i.e. a government deficit combined with a balance of payments deficit.

The above processes can easily be reversed, however, in the event of a sudden decline in confidence in a country's economic prospects. On the assumption that equity prices are likely to fall in the future, foreign holders of such equities will try to offload them as soon as possible. The resultant fall in equity prices will lead to a rise in effective interest rates for the government, restricting its borrowing potential and pushing up interest costs. Moreover, the government may be forced to raise official interest rates even further in order to shore up the local currency. At the same time, falling collateral values will put the lid on private-sector lending.

Spending in the public or private sector – or in both sectors at the same time – may contract, slowing down growth and reducing job opportunities. This is not just an economic theory: both India and Turkey have experienced this very situation in recent times. Although low-income countries should in principle welcome international investors taking a greater interest in their economies, they should draw certain lessons from the recent cases (as referred to above) of middle-income countries that have seen massive fluctuations in capital flows. Such lessons could include pursuing an effective counter-cyclical policy and controlling the volume of capital flows. The international financial architecture could assist such countries by seeking to enhance stability in general and by offering counter-cyclical finance (including 'shock funds'), sound advice and the possibility of regulating international capital movements (i.e. both supply and demand).

IV.12 Summary data on low-income countries

Low Income Countries, Capital Flows and other selected data

Countries	Pop. 2012 m	ec. size GDP 2012 Curr. USD m	FDI net inflow 2012 USD m	Portf. flow 2012 USD m	ODA 2011 USD m	net ODA per capita USD, 2011	Fragile State OECD/DAC 2013	Corruption persp. index 2013 score 100 = clean	Corruption persp. index 2013 ranking out of 177	Ease of doing buss. index ranking 2013 out of 189	WB governance indicators range -2,5 to +2.5	export goods+serv. % GDP 2012	intl. trade goods+serv. % GDP 2012
Afghanistan	30	20.497	94	2	6.711	231	x	8	175	164	-1,75	6	
Bangladesh	155	116.355	1.178	91	1.498	10	x	27	136	130	-0,87	23	23
Benin	10	7.557	159		672	69		36	94	174	-0,29		24
Burkina Faso	16	10.441	40		996	62		38	83	154	-0,38		25
Burundi	10	2.472	605		579	61	x	21	157	140	-1,19	29	6
Cambodia	15	14.038	1.557		792	54		20	160	137	-0,78		57
Central African Rep.	5	2.184	71		272	61	x	25	144	188	-1,30	12	10
Chad	12	12.887	323		468	39	x	19	163	189	-1,30	29	
Comoros	1	596	17		52	74	x	28	127	158			15
Congo, Dem. Rep.	66	17.204	2.892		5.532	87	x	22	154	183	-1,64	55	63
Eritrea	6	3.092	74		135	23	x	20	160	184	-1,40		
Ethiopia	92	41.605	279		3.532	40	x	33	111	125	-0,96	14	18
Gambia, The	2	917	34		135	78		28	127	150			35
Guinea	11	5.631	605		201	18	x	19	163	175	-1,19	30	35
Guinea-Bissau	2	822	16		119	73	x	24	150	180		17	25
Haiti	10	7.843	179		1.712	171	x	19	163	177	-1,16	13	13
Kenya	43	40.697	259	26	2.484	59	x	27	136	129	-0,69	27	
Korea, Dem. Rep.	25		79		118	5	x	8	175				
Kyrgyz Republic	6	6.475	372		523	95	x	24	150	68	-0,83	49	
Liberia	4	1.734	1.354		765	188	x	38	83	144	-0,74	32	65
Madagascar	22	9.975	895		441	20		28	127	148	-0,71		27
Malawi	16	4.264	129	1	804	52	x	37	91	171	-0,33		29
Mali	15	10.308	310		1.270	88		28	127	155	-0,49		26
Mozambique	25	14.243	5.238		2.071	84	x	30	119	139	-0,30	30	30
Myanmar	53		2.243		376	7	x	21	137	182	-1,65		17
Nepal	27	18.963	92		892	33	x	31	116	105	-0,89	10	9
Niger	17	6.773	793		646	39	x	34	106	176	-0,58	25	23
Rwanda	11	7.103	160	7	1.262	113	x	53	49 !	32 !	-0,21	13	13
Sierra Leone	6	3.796	548	7	424	72	x	30	119	142	-0,64		19
Somalia	10		107		1.096	111	x	8	175		-2,30		
South Sudan	11	10.220			1.087	105	x	14	173	186	-1,48	10	
Tajikistan	8	6.972	198		355	45	x	22	154	143	-1,10	18	
Tanzania	48	28.242	1.707	4	2.436	53		33	111	145	-0,36	30	31
Togo	7	3.814	166		557	86	x	29	123	157	-0,89		40
Uganda	36	19.881	1.721	5	1.582	45	x	26	140	132	-0,59		25
Zimbabwe	14	9.802	400		716	54	x	21	157	170	-1,47	44	
Totaal		**467.403**											
Data source	world	development	indicators					Transparancy Internationa		WB/IFC	world dev. Ind.	world dev.ind.	WTO world trade statistics 2012

LICs Financial Systems Structure Indicators

% of GDP, average 2005 - 2010

	Stock Market Capitalization	Bank Assets	Insurance Assets	Pension Assets
Afghanistan		8		
Bangladesh	8	53	2	
Benin		21	2	
Burkina Faso		18	1	
Burundi		23		
Cambodia		17	1	
Central African Rep.		9	1	
Chad		5		
Comoros				
Congo, Dem. Rep.		3	1	
Eritrea				
Ethiopia		27	1	
Gambia, The				
Guinea		8		
Guinea-Bissau				
Haiti		15		
Kenya	38	39	8	
Korea, Dem. Rep.				
Kyrgyz Republic	2	10		
Liberia		11		
Madagascar		12	2	
Malawi	20	13	6	
Mali		19	1	
Mozambique		24	3	
Myanmar		4		
Nepal	29	46	1	
Niger		10	1	
Rwanda		12		
Sierra Leone		11		
Somalia				
South Sudan				
Tajikistan		15		
Tanzania	4	19	1	
Togo		23	2	
Uganda	10	16	1	
Zimbabwe				
Average LICs	18	15	1	
Average High Income	70	99	26	12

Source: WB 2014 World Development Report, Data annex

Blank = zero or no data

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** Joint report by the Advisory Council on International Affairs (AIV) and the General Energy Council.

*** Joint report by the Advisory Council on International Affairs (AIV) and the Advisory Committee on Aliens Affairs (ACVZ).