Report

Maximising international finance for development in the poorest and most vulnerable countries

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Key messages

Private capital flows have the potential to provide essential financing for developing countries for economic growth, but are subject to risks, as well as opportunities, that have been highlighted by the global financial crisis. This paper examines the related post-crisis trends and issues and propose policy options to support positive outcomes.

In this paper risks to these positive trends and related possible policy options are discussed. We suggest that a **future coherent policy on LIC financial architecture needs to focus on four key themes**. These are:

- Promoting **positive impacts from developed country policies**, including greater international coordination (e.g. in the G20)
- Promoting **a more effective voice for LICs** in the on-going reforms of global economic and financial architecture (e.g. in the Financial Stability Board)
- Using **aid and shock facilities** to leverage capital for addressing long term gaps and supporting flows in times of crises, especially in the poorest and most vulnerable economies
- Supporting **capacity building** in LICs for regulatory and institutional development.

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1. Introduction

The current positive trends in cross-border flows to LICs offer an opportunity to mobilise resources for development to support the expected continued strong growth for LICs (IMF, 2014; United Nations, 2014). Nevertheless further resource mobilisation, including from cross-border flows, remains critical, as does developing deep and robust financial systems that allows them to be intermediated effectively and to be supplemented by growth in domestic resource mobilization (United Nations, 2013a). This paper discusses the associated risks and policy implications of these issues.

Risks remain an area for concern as highlighted by the IMF (IMF, 2014), World Bank (2014) and Hou et al (2014). Risks relate to both excessive contraction and expansion of flows because both scale and stability are important to ensure positive interaction with growth (Massa, 2013). Further, financial markets in LICs remain susceptible to instability because recent progress in deepening (Beck et al, 2011), including integration with global markets, can increase contagion risks. However, they remain shallow with missing markets in intermediation, underdeveloped capital markets, limited financial access and with weak regulatory capacity. Such characteristics, combined with macroeconomic susceptibility in LICs to both endogenous and exogenous shocks, require the key goals of policy to balance growth and deepening of financial markets with stability and pro-development impacts.

The paper will begin with an overview of LIC-relevant policy initiatives since the financial crisis, so that the context of future policy options can be reviewed. The paper will then discuss the major “pull” and “push” risks for LICs capital flows, before drawing these two themes together to review future policy choices.

2. Post-Crisis Policy Initiatives

The global financial crisis caused significant disruption to advanced economies, as well as emerging economies, and focused global policy attention on the need for reform of domestic and international monetary and financial architecture. At the time of writing, many initiatives continue to be in discussion, rather than implemented, and the architecture that will emerge remains to be fully determined (Ocampo, 2014). However, there are three main areas of reform relevant to LICs.

Firstly, central to the reforms has been a strengthening of domestic financial regulation and supervision. These initiatives were led by the G20 and the Financial Stability Board ("FSB"). Most importantly for LICs, the Basel Committee on Market Supervision issued new regulatory standards, known as Basel III (Basel Committee, 2010). These standards augmented the preceding Basel II standards by introducing more stringent requirements for capital, liquidity and leverage, including counter-cyclical requirements. Also important for LICs has been a shift in domestic regulatory frameworks to give a stronger emphasis to macro-prudential, as well as micro-prudential, regulation. This has included establishing new regulatory bodies, such as the US Financial Stability Oversight Council, the European Systemic Risk Board and the UK Financial Policy Committee.

The relevance to LICs relates to two main issues. Firstly, Basel II & III have established an effective consensus in global standards for regulation of domestic financial systems, including micro-prudential regulation, but one that may not be both theoretically appropriate for LICs nor within their near-term capacity to implement. This is because Basel II established standards designed to manage highly complex risk books and for institutions with related risk management systems. Further Basel III counter-cyclical proposals assume mature economies which experience periodic cycles. However, in LICs there may be limited applicability of the proposed frameworks because LIC institutions do not manage these types of complex risks, nor have the required institutional capacity relating to them, and because LICs are undergoing structural transformation, in addition to cyclical change (Gottschalk, 2010). Secondly, concerns have been raised as to the impact of Basel III on international banks lending appetite to LICs because it raised the cost, via capital requirements, of lending to riskier sectors and penalises lending to sectors without established default histories. Such requirements may squeeze credit in areas important to LICs, including financial inclusion and long-term infrastructure (United Nations, 2013a; United Nations, 2014). This will be discussed further below.

Secondly, there have been reforms to international financing institutions including, in particular, improvements to counter-cyclical financing and shifts in key policy stances, including in relation to cross-border capital flows. This includes at the IMF, multilateral development banks and through regional institutions and arrangements. In relation to counter-cyclical financing, IFIs responded to the crisis with a counter-cyclical expansion of financing (Ocampo et al, 2010; Velde, D. te and Griffith-Jones, S., 2013). This included at the IMF and MDBs, both of whom established new credit facilities. There were also a number of regional and bi-lateral initiatives, such as the Chiang Mai initiative, which expanded multilateral swap lines, and through Central Banks QE programmes and bi-lateral swap lines and such initiatives are expected to be further strengthened given the failure to ratify the reform of IMF quotas by Congress in January 2014. However, MICs, not LICs, were the main beneficiaries of these initiatives. For example, expansion of lending by IFIs largely excluded LICs (Griffith-Jones & Ocampo, 2012). Also, LICs were almost entirely excluded from a number of initiatives, including the Chiang Mai and bi-lateral swap lines, and are at a disadvantage in bi-lateral discussions because of their relative economic positions (Ocampo, 2014).

However, LIC-relevant initiatives have included new facilities at the IMF, World Bank and MDBs. The IMF reformed concessional facilities for LICs in 2009 and 2013 to create more flexibility and less conditionality, as well as implementing zero interest rates on facilities until 2014 (United Nations, 2013a). The World Banks' new facilities included shock financing and social welfare and food programme financing for IDA countries. These initiatives are discussed further below.

In relation to policy stances - which have been influenced not only by technical work at IFIs, but by the effectiveness of policy in reducing vulnerability of developing countries during the crisis (Ocampo, 2014) - there has been a shift towards support for capital account management. Indeed, there is a gathering consensus that capital account regulation should be seen as a complement to, although not a substitute for, macroeconomic policy (e.g. fiscal, monetary and exchange rate policy). However, it remains controversial as to whether such tools should be viewed only as "interventions of last resort" (IMF, 2012) or as part of a continuum of regulatory tools (Ocampo, 2014).

Thirdly, there has been discussion relating to improvements in macroeconomic coordination and international monetary reform, although executed reforms have been very limited. LICs, however, are not well represented in the relevant forums. This is despite the fact that, as LICs integrate with global financial systems, including through cross-border flows, they became increasingly vulnerable to the risks associated with them and this can result in reduced autonomy in monetary and fiscal policy, as well as risk of developmentally costly crises. As a response, there has been an increase in reserves in LICs which, by 2012 reached 9% of GNP, as "self-insurance" against capital accounts disturbances (United Nations, 2013a) which, while strengthening their domestic robustness against volatile capital flows, also carry a high opportunity cost for capital-scarce LICs (Ocampo, 2014).

3. Risk Factors

3.1. International "Push" Risk Factors

3.1.1. Reversal of Advanced Economies Loose Monetary Policy

A critical factor in cross-border capital flows to developing countries is the economic and financial conditions in advanced economies. Since the crisis, the most important of these has been the exceptionally loose monetary policy, with record low interest rates and unconventional quantitative easing, in advanced economies which has driven rebalancing of international investor's portfolios in favour of relatively high-yielding assets in developing countries.

However, this "push" factor is susceptible to reversal as, and when, quantitative easing is unwound and interest rates return to long-term average levels. Central Banks in advanced economies are focused on achieving unwinding so as to ensure its' impact is orderly[1]. However, even during an orderly unwind, it can be expected that there would be negative pressure on cross-border capital flows to LICs and, although a gradual unwind would allow recipient countries to adjust in an orderly manner, it is likely that subsequent medium term flows will be impaired towards pre–crisis levels (World Bank, 2014).

Further, there is a possibility of a disorderly unwind that would result in an acute and significant contraction in flows (Velde, 2013; World Bank 2014). Indeed, this scenario occurred in mid-2013, when market views of the timeframe for monetary tightening in advanced economies shortened and resulted in sharp increases in U.S. Treasury yields. As a response, emerging market bond and equity markets experienced very large outflows and surging yields and many developing country currencies depreciated sharply, especially in countries with weak fundamentals, such as high government and current account deficits (Rey, 2013).

3.1.2. Excessive and Volatile Portfolio Flows

Further, as well as simple search for yield, global inflows from investors have also been driven by positive investor sentiment since the global crisis. As discussed, in 2012 and 2013, a number of substantial investor funds were established focused on "frontier markets" which reported a 2013 average return of 26% for Africa-based funds and drove a near doubling of related indices (Source: MSCI Index). Such funds saw large inflows, including from speculative and non-regulated investors such as major hedge funds and private equity vehicles[2], and which resulted in early 2014 in FINCA, the US regulatory body, issued a warning relating to such funds marketing investments to non-professional investors.

Whilst such flows funded the strong bond issuances in Sub-Saharan Africa in 2013 discussed in paper '*Post-Crisis Trends in Private Capital Flows to Developing Countries'*, such "hot money" can be subject to boom-bust cycles in investor sentiment that make them highly unstable and vulnerable to capital flow reversals or sudden stops. Indeed, econometric evidence on the effects of short-term capital inflows suggests that portfolio flows in LICs has a neutral or even negative effect on growth (Massa, 2013; Hou et al, 2014) and Sub-Saharan Africa is seen as particularly susceptible to the impact of surges and stops in portfolio flows because of its relatively small GNP (World Bank, 2014). Such speculative inflows have also been a key causative factor in previous developing country crisis, including in Asia and Latin America, as their financial market became integrated with global markets, including because of premature capital account liberalisation.

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[1] For example, the Bank of England's MPC commented in the Governors letter to the Chancellor in August 2013 that future conduct of monetary policy and forward guidance was subject to "material risks to … financial stability" (Bank of England, 2013).

[2] This has included a broad range of international investment banks, hedge funds such as Blackrock and private funds such as that led by Bob Diamond, the former CEO of Barclays forced to resign in disgrace after the LIBOR scandal, whose $325million fund is focused on financial service investments.

Overall, a risk factor may be emerging relating to excessive and unstable portfolio flows into LICs which warrants consideration of policy measures to stabilise such flows and ensure they are directed to pro-development uses.

3.2. Domestic "Pull" Risk Factors

3.2.1. Domestic Macro-Economic Resilience

Strong macroeconomic fundamentals and anticipated differential growth rates are important factors in attracting private capital flows (World Bank, 2014) but the ability of domestic policy to manage them to realise benefits and to minimise risks is important. Surges in capital inflows may lead to upward pressure on exchange rates, as well as to inflationary pressure, thus affecting developing countries domestic policy objectives, such as export promotion, exchange rate stability and inflation targets.

Many LICs have made recent improvements in macroeconomic policies and institutional frameworks and policy buffers are reaching pre-crisis levels (Hou et al, 2014). For example, LICs are experiencing improving growth rates, lower government deficits and improved current account balances (Hou et al, 2014; IMF, 2013a and 2014).

However, improvements are limited and LIC remain vulnerable. In particular, there is vulnerability amongst LICs and LMICs with large account deficits, especially where they are reliant on foreign capital for financing, such as in Kenya, in commodity-exporting countries and in fragile states. Economies with high inflation rates and fiscal problems are also more vulnerable (IMF, 2013, 2014). Consequently, LICs need to continue to build domestic economic resilience.

3.2.2. Domestic Financial Stability and Deepening

As well as macroeconomic resilience, it is important that receiving financial systems for private capital flows are robust enough to receive them without threatening financial stability. Many LICs are experiencing rapid growth in the financial sector, including private sector credit relative to GNP and expansion of financial access (Beck et al, 2011) and increasing early-stage integration into global financial markets.

Progressive and stable development and integration of the financial sector is to be welcomed. However, the quality and pace also needs to be appropriate, especially as deepening of domestic financial systems amplifies exposure to transmission of global financial shocks. Where financial systems are weak, large and rapid outflows can cause liquidity and asset market problems, while, conversely, large capital inflows may foster asset price bubbles and a too-rapid expansion of credit.

Worryingly, in LICs there are some less positive indicators in relation to these issues. For example, banking institutions have increased leverage and liquidity risks, including through wholesale markets, and asset quality remains vulnerable to deterioration in domestic economies (IMF, 2013b). There is also evidence of excessive domestic credit growth in some sectors and asset-bubbles driven by speculative flows. For example, in 2012 and early 2013 stock price rallies occurred in a number of African LICs such as Kenya, Tanzania, and Uganda, linked to international capital inflows (IMF, 2013a). Further, domestic credit expansion has been linked to developmentally sub-optimal expansion of consumer lending and housing (Velde, D. te & Griffith-Jones, S. 2013; Tyson, 2014). Such issues can lead to boom-bust cycles in consumption and asset markets, deteriorating banking asset quality and diverts scarce capital from pro-development investment in agriculture, industry and infrastructure.

4. Future Policy Options

We suggest that a coherent policy on the international financial architecture needs to focus on a four fundamental themes to assist LICs in realising the opportunities and manage the risks of cross-border capital flows: These themes are as follows;

4.1. Promotion of positive impacts from developed country policies on private capital flows to developing countries

As discussed, private capital flows to LICs have become increasingly dependent upon global “push” factors as well as domestic “pull” factors. In particular, the current critical risk to LICs cross border flows is the anticipated shift in global monetary policy, especially the unwinding of loose monetary policy in advanced economies.

As such, there is a requirement for greater consideration of the impact of advanced economies policies on LICs from domestic and international institutions, particularly those responsible for financial stability and economic prosperity. However, although the issues are widely discussed, including within international fora such as the G-20 and at the World Economic Forum, LICs are less well represented in these fora and consequently insufficiently considered. In addition, within national bodies, there is currently minimal consideration of supra-national spill-over effects of domestic policy as regulators and policy-makers may not consider this within their mandates.

However, greater consideration would not only address responsibility towards the poorest and most vulnerable countries, but address the reality that in the global economic and financial system, spill-over effects have feedback mechanisms, not only from, but to advanced economies in relation to developing economies, including through trade and financial stability.

Similarly, the G20 agenda relating to finance in the post-2015 development goals could be more effective if there was a new partnership between the G20 and developing countries. It could, for example, set explicit objectives to leverage G20 investment for the benefit of G20 and LICs, co-ordinate capital management between both recipient and sender countries to the benefit of both and coordinate spill-over issues, such as monetary policy, tax base erosion, illicit capital flows and profit shifting.

In particular, in relation to tax, a G20 report in 2011 called for a global action plan to address base erosion and profit shifting and there have been discussions relating to establishing multilateral information exchanges and improved territorial-based taxation. The impact on LICs need to be full assessed but might, for example, include greater transparency of capital outflows and offshore assets, fairer assessment of transfer pricing and impacts on business activities. However, further study of spill-over effects of changes in tax systems for LICs are needed. However, overall, international cooperation is to be welcomed especailly in relation to coordination in tax evasion, avoidance, transparency and transfer pricing (te Velde, 2013a, 2013b).

4.2. Promoting an effective voice for LICs in global financial architecture

As discussed, consideration of LICs in developed country policy-making is limited. This can partially be attributed to the lack of an effective voice for LICs in the various international bodies which discuss and set global financial infrastructure. For example, of the 27 nations whose central banks are represented on the Basel Committee, and of the 24 nations represented on the FSB, there are 7 MICs and no LICs.

As a consequence, consideration of the relevance of on-going reforms to LICs is limited. This was reflected by the FSB themselves who, in 2011 and 2012, highlighted important gaps and consequences of recent reforms, including unintended ones, for developing countries. These included issues highly relevant to LICs such as, as discussed, the need for adaptation of Basel III, as well spill-over effects of changes in risk and credit management (Such as the Volcker rule or the reliance on credit agencies). It also highlighted the need for further improvements in international cooperation and responsibility in supervision and the need for bilateral supervisory arrangements (FSB, 2011, 2012).

However, although these important issues and gaps have been highlighted by the FSB, firstly, little has been implemented to effectively address them and, secondly, the focus remains on MICs with large economies which have relatively well-developed and globally integrated global financial systems.

Further strengthening is needed in relation to LICs. For example, LIC representatives should be added as members of the Basel Committee and in their committee observers and Expert Sub-Committees members.

4.3. Extending Aid and Shock Facilities

As discussed, IFI responses were very important during and after the crisis in providing counter-cyclical financing to developing economies, including LICs. However, this needs to be extended. We suggest three main areas where this could be done, highlighting that all need to continue to provide concessional financing to LICs to ensure debt levels remain sustainable.

4.3.1. Strengthening Anti-Cyclical Financing & Shock Facilities for LICs

As discussed, there has been considerable reform of IFIs facilities in response to the financial crisis, including expansion of counter cyclical financing and reform and renewal of related facilities.

However, initiatives lacked participation of LICs and further strengthening of LIC-oriented shock facilities is needed. In particular, concessionality needs to be reviewed as, although, for example, the new IMF facilities incorporate concessional lending rates, they continued to maintain conditionality in relation to "macro-relevant" issues[3] for LICs (Griffith-Jones and Ocampo, 2012).

A further option is to augment official liquidity and development finance to play a more important role in mitigating the impact of shocks. However, an important policy question is, if more emphasis is placed on dealing with shocks, what is the potential trade-off in allocating reduced funds to other development activities (Griffith-Jones, 2012).

4.3.2. Extending Long-Term Development Financing

Long-term financing is essential for raising the resources required for structural transformation of developing economies, particularly for infrastructure, including for green technologies, and for public sector investments in health, education and other social sectors. As discussed above, recent trends in capital flows from private markets have been positive for LICs, including in FDI and sovereign bonds issuances. However, IFI policy to further strengthen both the scale and stability of private sector flows would be welcome.

This could include continued support for IFI financing on a concessional basis, especially for long maturities, as these remain important to close "missing markets" because private sector flows continue to be subject to uncertainty as to their scale, cost and maturity because they are subject to volatile international investor sentiment. Further, renewed private sector bond issuances may create future unsustainable debt burdens, given the non-concessional terms. This is especially the case for the poorest and most vulnerable LICs who, as

[3] The IMF defined these in 2002 to include issues such as tax policy and administration public expenditure management and financial sector reform (IMF, 2013a).

discussed earlier, are excluded from substantial private capital markets and are particular vulnerable to becoming overburdened in relation to debt obligations.

An important role exists for continued and strengthened representation of these issues in relevant IFI-related forums to ensure that long-term and concessional financing is maintained for LICs.

In addition, more innovative products and structures could also be considered. For example, guarantee and insurance programmes have proved effective in supporting private capital flows for development, including into high-risk sectors and countries, such as public-private partnership infrastructure projects (World Bank, 2009). Other new instruments have already been successful, such as venture capital or equity funds, and innovative risk management programmes, such as for foreign exchange or political risk, and could be developed further.

Such programmes could be supported at IFIs and extended through bilateral or multilateral programmes.

4.3.3. Supporting Marginalised LICS and MICs through ODA

As discussed some LICs and smaller MICs are marginalised or excluded from cross-border capital flows, often having a heavy reliance on ODA as their main source of cross-border capital. ODA needs to complement and leverage private capital flows for these countries. One manner in which this can be done is to ensure that ODA is focused on those countries with the lowest ability to access private and it is important that development agencies continue to provide and advocate for such sources of capital to be concentrated in these countries with the greatest needs.

4.4. Supporting capacity building in LICs for regulatory and institutional development.

The need to build institutional capacity has been a consistent theme of development policy at IFIs. However, such capacity building needs to be continued, especially in the government and financial sector, to manage the domestic risks discussed earlier.

In relation to macroeconomic capacity, many LICs need to continue to build capacity in public institutions with responsibility for planning and executing macro-economic management and public programmes. In particular, there is a need to develop appropriate capital account management policies and execution within LICs that will allow them to ensure positive outcomes from capital flows.

Similarly, in the financial sector, public institutions, including central banks and regulators, need to strengthen capacity. However, in addition, private institutions, including banks, need to also continue to have incentives for pro-development lending enhanced and assistance provided to build internal capacity that matches their increasing scale and risk profiles. For private financial institutions, especially systemically-important ones, it is important that micro-prudential regulation continues to be strengthened, including enhanced monitoring and management of risks, such as excessive dependence on wholesale and external funding, declining asset quality, and foreign currency mismatches.

There is also a need to develop macro-prudential regulatory capacity. As discussed, this includes a need to adapt global financial regulatory standards to make them more appropriate to LICs. In particular, Basel III needs to be adapted to the differential financial structures of LICs. Further, there is a need to build an international consensus of the appropriateness of such adaptations so that private capital flows are not impaired.

Continued targeted support for such capacity building is an important area. Support could include well-established approaches, such as support of training and technical advice. However, newer approaches are also being developed that could be considered.

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