

Supporting Global **Growth**

A preliminary report on the responsiveness and adaptability
of the international financial institutions
by the Chair of the London Summit

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The G20 Remit

At the London Summit, G20 Leaders agreed the need to strengthen the longer-term relevance, effectiveness and legitimacy of the International Financial Institutions (IFIs) to ensure that they could help manage the current crisis and prevent future crises.

As part of this, the chair of the London Summit was asked to 'consult widely in an inclusive process and report back to the next meeting with proposals for further reforms to improve the adaptability and responsiveness of the IFIs'.

SUPPORTING GLOBAL GROWTH



A PRELIMINARY REPORT ON THE RESPONSIVENESS AND ADAPTABILITY OF THE INTERNATIONAL FINANCIAL INSTITUTIONS BY THE CHAIR OF THE LONDON SUMMIT

REPORT BY THE PRIME MINISTER

At its Washington and London Summits, the G20 came together to fight back against the global recession. By coordinated international action, the world stabilised the banks, agreed new regulatory principles, and created contingency funding for emerging markets that faced problems because of the state of global capital markets.

We delivered a concerted fiscal response worth in total 5 per cent of GDP both this year and next, as well as the full array of conventional and unconventional monetary policy measures. Many independent commentators have since said the unprecedented nature of our international co-operation helped avert a significant deepening of the crisis. The US Council of Economic Advisers concluded that for every extra 1 per cent of GDP in discretionary fiscal stimulus, countries grew 2 per cent growth faster.

We must continue to implement our financial support measures and expansionary monetary and fiscal policies until recovery is secured, consistent with price stability and long-term fiscal sustainability. Based on the ILO's analysis, I believe that the fiscal stimulus we have agreed for this year and next will, if fully implemented, save or create around 15 million jobs.

But while we are no longer staring into the abyss of last year, the need for international cooperation is even greater now than it was then. Because we still need to secure the recovery and to find, globally, the path to sustained and balanced growth.

The stakes are high. With strong and successful co-operation the IMF suggests that by 2014 world output could be more than a tenth higher – about \$6 trillion –

than if we pursue weak or counterproductive policies. That would be the difference between strong growth in jobs, increasing prosperity and poverty reduction on the one hand, and high levels of unemployment and worsening hardship for lower income countries on the other.

The International Financial Institutions and architecture have a crucial role in supporting these goals. As we develop and agree a new, more robust, 21st century approach to governing our international economy, we need international financial institutions with the capacity and effectiveness to support our needs in a world of global capital flows.

That is why we agreed in London to strengthen the relevance, effectiveness and legitimacy of the IFIs to enable them to prevent future crises. As agreed in London, I am reporting back in advance of discussion in Pittsburgh on further reforms to increase the responsiveness and adaptability of the IFIs, to meet the challenges of globalisation. I am grateful for the responses to the wide consultation which has underpinned the formulation of the ideas in this report and look forward to further responses to the ideas in these papers. I hope Leaders can take them forward together.

The key lesson of the crisis is that in an increasingly interconnected global economy we need both stronger economic coordination and more effective international financial institutions and architecture to support this, and a stronger framework of financial regulation, recognising the imperfections and risks in global markets. The technical report sets out the ideas here in more detail.

A global compact for growth and stability

I propose a global compact for growth and stability to secure both the recovery and sustainable and balanced growth over the medium to long term. Above all, this compact must be based on a strong political consensus from G20 countries to co-operate to advance our prosperity, grounded in the recognition that our economies are highly interdependent.

The compact would have three central objectives:

- first, we must make every effort to support the recovery and plan coordinated exit strategies from our current expansionary measures to make sure that the recovery is not put at risk;
- second, we must agree a framework for how each of us over the medium term can best contribute to worldwide growth, including through structural reforms, to benefit jobs in all our countries, and that this growth is balanced and sustainable; and,
- third, we must reform and strengthen the governance of what is now a global financial sector.

This compact should be grounded in the principles and values set out in the proposed Charter for Sustainable Economic Activity.

In the past we have had political statements on the need for measures that require co-operation, but these have not been backed up by robust economic analysis and action. And we have had multilateral surveillance, which has lacked the political decision-making needed to give it traction.

The emergence of the G20 as a central part of our economic governance gives us a historic opportunity to provide real political leadership on the economic policy measures needed to create and sustain growth. In order to deliver this, we need a concrete framework which sets out how our objectives will be set, how we decide on the measures we need to take, and how we will follow up on the results.

We need a new framework under which political Leaders assess together economic policies which may affect each other, with political decision-making by the G20 countries underpinned by the best possible economic expertise and analysis. This should be based on the following essential elements:

- explicit agreement, regularly assessed, by the G20 on our common objectives of balanced, sustainable and enduring growth;
- a commitment by each country to set out its medium-term policy framework, showing how it will contribute to the common objectives;
- analysis provided by the IMF on the situation and risks in the world economy, working together with the Financial Stability Board on the interaction of financial and economic risks, drawing on other institutions as needed. This should include analysis of the consistency of our economic plans with our overall objectives for sustainable and balanced global growth;
- clear mechanisms to warn us when we are off track to deliver our objectives, so that governments can take decisions on the need for action based on the best possible information; and
- political agreement on the policy actions needed to address any risks and problems.

Our Finance Ministers should be tasked with working through the details of this process when they meet next at St Andrews in November, with further development to go forward through the Finance Ministers' process. We should then review the economic situation when we next meet.

But at Pittsburgh I propose we do more than just launch this new process. We should have an agreement now to deliver strong economic co-ordination as we face a period of uncertainty in the recovery, as we look forwards to decisions on the nature and timing of exit strategies, and as we start on the road to securing a more stable balanced

and sustainable global economy.

I therefore propose that we launch the compact by agreeing that we are committed to high levels of growth on a sustainable and balanced basis. The IMF estimates that world growth in real terms will resume this year and rise to nearly 3 per cent by the end of 2010, on the way to sustained recovery. As I have noted, they have also reported the higher levels of growth we can obtain by pursuing policies for sustainable and balanced growth. We should commit to put in place the necessary policy measures to achieve these ambitious outcomes. That will require coordinated and consistent policies in all our economies over a number of years, many of them structural reforms.

To support this compact we need to reform the International Financial Institutions to be effective and credible:

- in preventing future crises by shifting their focus from bilateral to systemic issues so that they can provide governments with the best possible advice;
- in combating economic shocks by helping deal with sudden stops in markets for project finance, and making crisis facilities faster acting and more flexible;
- in supporting the needs of the poorest countries; and
- in supporting our global efforts to combat climate change.

As an integral part of these reforms, we need to make the governance of the IMF and World Bank more robust and representative of emerging and low income countries, each reflecting their respective mandates. As the governance of the IMF is reformed we should look to bring the membership and structures of the G20 closer to that of the IMFC.

Preventing future crises

To strengthen the role of our institutions in supporting the compact:

First, we should change the main focus of IMF analysis away from individual countries and towards systemic issues which affect us all, including global and regional surveillance, analysing levels and trends in macroeconomic imbalances, assessing the consequent systemic risks and providing policy recommendations. We need a dedicated multilateral policy department of the Fund to ensure they can adequately address these risks.

Second, we should give the IMF an objective to support financial stability, alongside the Financial Stability Board, to build on the capacity it has developed over the last decade, and ensure it can recognise and give early warning of risks flowing from the financial sector to the real economy.

At the same time, we should strengthen the role of the Financial Stability Board, founded at the London Summit but faced with growing demands. We should strengthen and make independent the resource base of this new institution and make it formally responsible to the G20. We should give the FSB a clear role in ensuring that international standards are developed effectively and within the necessary timeframe and reporting on progress to the G20.

Third, we should look to make the IMF's regular bilateral surveillance activity on specific countries more independent, more credible and more effective, building on the work already achieved. Countries should agree in advance that their Article IV reports should be public and the Fund must be seen to be empowered and equipped to present views independently of political interference, with the Governors holding management accountable for overall delivery.

Combating economic and financial shocks

In an integrated global economy and with global capital markets, we must ensure that the IFIs have the tools and resources they need to be able to respond and adapt to new challenges.

The \$1.1 trillion we committed to at the London Summit gave a massive boost to confidence, especially in emerging markets. In the future, the IFIs need to be able to help countries insure themselves against the risk of future crises.

When they face a shock, such as the capital market shocks recently experienced, countries need to know that they can access finance quickly and on the scale required. In turn, this will reduce the incentive to hold foreign exchange reserves and allow them to be channelled into productive investment.

The World Bank and the MDBs should be recognised for the part they have played in responding to the crisis and supporting world demand. I believe they must do more - making greater use of guarantees and putting mechanisms in place so that when triggered by future crises, they can increase their gearing and maximise the use of their capital.

We must ensure the MDBs are capitalised to meet the future needs of the global economy, including considering general capital increases. But this must be accompanied by rapid progress on strengthening governance and accountability, and increasing operational effectiveness to give shareholders greater confidence that resources provided to and through the Bank will reduce poverty and foster sustainable growth. At the World Bank in particular there is a need for including a significant increase in the voice and representation of emerging and developing countries and especially the poorest. The IMF has made real progress with its new Flexible Credit Line. But more still needs to be done. Assessment for the FCL should be an automatic and systematic part of the process of surveillance of economies. And we need to bring together regional and bilateral arrangements so they can play a role

alongside the IMF in the provision of financial support, within a coherent and consistent framework.

Through these measures we should reduce the need for countries to accumulate reserves, freeing up resources to use for productive investment as a source of growth. As part of that we should be encouraging innovative use of financing by sovereign wealth funds and other private investors. I propose that the G20 should also look to the World Bank to support a 'Fund of Funds' mechanism financed and managed by the private sector to attract investment from sovereign wealth funds so that reserves can be invested more efficiently in developing country infrastructure.

Supporting the poorest

The global economic crisis has hit hardest many of the poorest nations of the world, setting back progress towards the Millennium Development Goals. International mechanisms to provide concessional finance flexibly and on the scale required have been found wanting.

Since London steps, have been taken to remedy this but more still needs to be done to provide much needed finance to help low income countries and support the growth and poverty reduction programmes that have been hard hit by the global downturn. I welcome the Fund's work in drawing up proposals to mobilise existing SDR resources for the poorest countries. We should urge all countries that have the resources to lend a proportion of their SDRs to ensure the IMF has the capital resources it needs to support lending to low income countries.

But I propose that we should agree to go much further with the urgent creation of a new crisis response facility at the World Bank to provide additional emergency funding to low income countries on IDA terms, financed through a mix of IBRD and donor contributions.

Addressing the challenge of climate change


A global agreement to address the challenge of climate change will require enhanced financial cooperation to support the development and transfer of green technologies, to reduce emissions from deforestation and to help the most vulnerable adapt.

Globally, we must deliver a substantial increase in public and private finance to support the design and delivery of ambitious climate adaptation and mitigation plans in developing countries. And we must underpin this finance with new institutional arrangements that are representative of developing, as well as developed countries; ensure strong financial management and coherence between instruments; and guarantee the provision of finance quickly and at scale in support of country-led climate plans, with a greater focus on supporting programmes as well as projects.

The World Bank and the other Multilateral Development Banks must prepare for an important role in these new arrangements: supporting the preparation of integrated national climate and development strategies, providing strong financial management for climate funding, and managing the delivery of key finance streams. In addition I propose the creation of a new high level body - fair, efficient and representative-to assess and provide guidance on needs and sources of funding, and to ensure that finance is allocated to the most pressing instruments and priorities.

Conclusion

Taken together these measures comprise a programme of reform that is a new way of governing the world economy - a way of governing that recognises our interdependence and our shared goals of growth, employment and a higher quality of life. I said at the London Summit that in this new world prosperity is indivisible, that the prosperity of each nation depends upon the prosperity of all, and that growth to be sustained has to be shared. This is not a time for complacency but a time for boldness.

A handwritten signature in black ink that reads "Gordon Brown". The signature is written in a cursive, slightly slanted style.

Gordon Brown
Prime Minister

THE ADAPTABILITY AND RESPONSIVENESS OF THE INTERNATIONAL FINANCIAL INSTITUTIONS: A TECHNICAL REPORT

EXECUTIVE SUMMARY

The International Financial Institutions (IFIs) have played a vital role in responding to the recent economic and financial crisis. However, the crisis exposed weaknesses and structural inadequacies in the international financial architecture and underscored the urgency of reforming the mandates, scope and governance of the IFIs to reflect changes in the world economy and the new challenges of globalisation.

A global compact for global growth and stability

The last decade has been characterised by high levels of growth built on: the globalisation of trade and capital flows, with truly global financial institutions at the centre of the global capital markets; the development of markets in some big emerging economies; and, technological change. But it is now clear that the global mix of macroeconomic and structural policies, particularly financial, before the crisis created instabilities and did not always support balanced growth. Market infrastructure, including international financial regulation, lagged behind requirements and there were long-term obstacles to the free flow of goods, services, capital and labour. Cumulatively, these factors reduced the sustainable growth potential of the world economy.

The financial and economic crisis revealed the full extent to which globalisation has led to the true interdependence of national economies and the potential for spillovers, particularly cross-border capital flows through the increased interconnectedness of financial systems. In

responding to the crisis the G20 has demonstrated that unprecedented levels of cooperation and coordination can make a real difference.

The decisive and concerted actions agreed at the Washington and London Summits have helped to stabilise financial markets and improve the outlook for the global economy. These include expansionary fiscal and monetary policies, financial support measures and our commitment to deliver a \$1.1 trillion programme of international financial support to restore credit, growth and jobs in the world economy – and globally coordinated action to reform financial regulation. The ILO estimates, on the basis of IMF calculations that the G20 fiscal expansion will have created or saved between 7 million and 11 million jobs in the G20 countries in 2009.

The priority is now to continue supporting jobs and the move to long-term, strong and more balanced growth. To achieve this, we will need to learn the lessons of the crisis and build on the structures for cooperation and coordination that have been established over the past year to manage the pressures of globalisation and reap the benefits. We must respond by intensifying our efforts to build policy consistency among G20 countries. It is also in this context that we must identify the role we want the IFIs to play in the post-crisis world and what reforms will be required to achieve this.

To support jobs and ensure sustainable and more balanced growth over the medium to long term, the G20 should agree a new global compact for growth and stability. The compact should have three central objectives:

- **first, the G20 must make every effort to support the recovery and plan coordinated exit strategies from current expansionary measures to make sure the recovery is not put at risk;**
- **second, the G20 must agree how each of us over the medium term can best contribute to worldwide growth, to benefit jobs in all our countries, and ensure that this growth is more balanced and sustainable, while maintaining long term fiscal sustainability; and,**
- **third, the G20 must reform and strengthen the governance and regulation of what is now a global financial sector.**

Above all, the compact must be grounded in a strong political consensus among the G20 countries, recognising that it is in their own interests to work together to support jobs and enable the world economy to achieve high levels of growth, without developing dangerous vulnerabilities.

To deliver this compact the G20 will need a concrete, country-led framework and new supporting structures that allow it to provide continued political leadership to global economic management. Recent history has shown that we need a structured approach to policy discussion and action between countries, particularly where decisions impacting on fiscal or monetary policy, structural economic reforms, or the financial sector have domestic political repercussions and must be maintained over long time periods. The limited impact of attempts to tackle risks in the global economy before the crisis demonstrate that to be successful these need to be grounded in political consensus on objectives, a commitment to deliver outcomes to achieve these objectives and then discussions within a more political forum, supported by the best possible technical analysis.

Learning from the success of its action to prevent a global depression and rescue the global financial sector, the G20 should build a supporting structure for cooperation and coordination, based on political decision-making underpinned by economic expertise. It should be a G20, country-led framework, including the following elements:

- **explicit agreement, regularly assessed, by the G20 on our common objectives of balanced, sustainable and enduring growth;**
- **a commitment by each country to set out its medium-term policy framework, showing how it will contribute to the common objectives;**
- **analysis provided by the IMF on the situation and risks in the world economy, working together with the Financial Stability Board on the interaction of financial and economic risks, drawing on other institutions as needed. This should include analysis of the consistency of our economic plans with our overall objectives for sustainable and balanced global growth;**
- **clear mechanisms to warn us when we are off track to deliver our objectives, so that governments can take decisions on the need for action based on the best possible information; and,**
- **political agreement on the policy actions needed to address any risks and problems.**

As its first step the G20 should commit to achieving a return of the world economy to the high levels of growth experienced before the crisis, but on a sustainable and more balanced basis. The IMF estimates that the difference between strongly and weakly coordinated G20 macroeconomic and structural policy actions, could add up to 2¼ per cent a year over the medium term – close to \$6 trillion in total at the end of 5 years – over a tenth of annual world output.

G20 Finance Ministers and Central Bank Governors should further develop this supporting process and structure at their next meeting in November in St Andrews and begin implementation, with further development work as needed to be taken forward through the Finance Ministers' process.

The compact can only be effective if supported by wide ranging reform of the functions and governance of International Financial Institutions. It is particularly important that the IMF's **legitimacy** is strengthened. Without this it will be more difficult to provide candid, even-handed analysis and act as a confidential and trusted adviser to the international community. Greater legitimacy will also remove some of the obstacles that have prevented the full use of its financial facilities in the recent past.

This reinforces the need for the G20 to deliver on the commitment made at the London Summit to fundamental IFI governance reform, as part of which the voice and representation of emerging and developing economies, including the poorest, must be significantly increased to reflect changes in the world economy, and the respective mandates of each institution. It will be vital to increase accountability of the IMF and World Bank to member countries, including through a more open, transparent and merit-based selection process for senior management. In addition, it will be critical to ensure a clearer focus on outcomes and accountability through a division of labour between Governors and Management, in particular by strengthening the role of Fund and Bank Governors in strategic oversight and reinforcing the operational effectiveness of IFI management.

For the IFIs to support the objectives of the compact in achieving high, stable and sustainable growth there will need to be further key reforms to ensure that:

- **IMF analysis and advice** is independent, credible and relevant and that the international institutions responsible for global financial stability are effective in preventing future crises;

- the international financial system is better equipped to assist countries **manage macroeconomic shocks**, reducing the need for precautionary reserves and supporting sustainable growth; and,
- critical **development challenges** are met both during times of crisis and relative stability, including responding to the **challenges of climate change**.

Preventing future crises

The crisis has powerfully illustrated the need for effective international agreements, underpinned by collaborative approaches and strong international institutions, to ensure long-term global financial stability. While important progress was made at the London Summit (e.g. in developing the remit and membership of the Financial Stability Board (FSB)), the scale and complexity of the international agenda and the urgency of making progress continues to grow.

The institutions dedicated to delivering financial stability should be strengthened to ensure that international **financial stability** systems keep pace with the demands placed on them and strong, supportive relationships are established between the IMF, the FSB and other relevant international bodies (e.g. the World Bank, BIS and OECD).

The FSB is responsible for micro-prudential policy, leading and co-ordinating the development of international regulatory standards and systems for responding to institutions in crisis. It also shares responsibility with the IMF for work on macro-prudential policy and risks.

The FSB has supported the G20 in achieving its objectives over the past year and has benefited from the G20's leadership. It is vital that the governance of the FSB is effective and builds on this established relationship, ensuring that the FSB remains accountable to appropriate political authorities. It will also be important that the critical role of independent national experts in setting standards is preserved.

The FSB's relationship with Leaders, G20 Finance Ministers and Central Bank Governors should be formalised. As one element of this, the FSB Chairman should report on the implementation of the G20 programme for regulatory reform, its activities and future work plan (with resource implications) to the G20. FSB reports should be a standing part of G20 Finance Ministers and Central Bank Governors' meetings, starting with their first meeting in 2010.

The FSB's relationship with standard setting bodies (SSBs) is also crucial to the overall functioning of the global regulatory system and needs to be strengthened.

To ensure stronger overview and coordination of the SSBs, the FSB should agree an MOU with each SSB, setting out clearly roles and responsibilities, and steps to be taken by the FSB, including reporting to the G20 on problems preventing the delivery of the required standards within the necessary timeframe.

Even after its expansion, and despite the key role of groups of national experts, the FSB's Secretariat will still only have a very small number of permanent staff. The staff are clearly under considerable pressure to keep up with rapidly growing demands.

To ensure that the FSB is adequately resourced and has the capacity to keep pace with growing demands, the G20 should call on the chair of the FSB to develop a medium-term business plan, identifying expected resource requirements and financing arrangements over a 3-year time frame. This should be shared with G20 Finance Ministers and Central Bank Governors at their next meeting in November.

It is important that the need for proper accountability to appropriate political authorities, an enhanced relationship with standard setting bodies (SSBs) and assurance of adequate resources are reflected in the new FSB charter and that this is agreed rapidly.

Far-reaching changes to the global economy (particularly the growth in volatile capital flows) have been accompanied by a series of increasingly serious shocks linked to financial crises, culminating in last year's global crisis. This has made it a high priority for the IMF to develop further its capacity to analyse macro-prudential risks. The role of the IMF also includes: analysis of global interactions between macroeconomic policy and financial stability; providing analysis, e.g. through the FSAP process, designed to reveal macro-prudential weaknesses in country financial systems; and provision of financial facilities to help countries adjust to financial market shocks (including capital flight). The IMF also has a critical role in working jointly with the FSB on the early warning exercise.

The IMF should examine whether it is adequately equipped to take on its role in financial stability as described above, with a view to ensuring sufficient prioritisation, an appropriate allocation of resources and management time, as well as a further strengthening of the close working relationships with other international institutions, particularly the FSB. A report should be presented to IMF Governors by April 2010.

Similarly, despite the increasing integration of the global economy, the focus of Fund surveillance remains primarily on individual countries and associated bilateral dialogues. But the Fund needs to place much more emphasis on **global and regional surveillance** (including analysis of systemic risks) and associated multi-country (multilateral) dialogues. Action should be taken to further strengthen multi-country surveillance at the IMF. For example, there is currently no single point of responsibility within the Fund for this type of surveillance and there is a need to bring together financial and macroeconomic analysis, presenting a comprehensive range of risks to policymakers.

The Fund should move to a system that places more emphasis on global and regional surveillance. A global surveillance department should be established to unify global financial and macroeconomic surveillance products.

Alongside these changes, it will also be necessary to enhance the **independence of the IMF's regular bilateral surveillance**, building on the Statement of Surveillance Priorities for 2008-2011 and clarifying the division of responsibility between members and management of the Fund, particularly with regards setting surveillance objectives and ensuring consistency with strategic direction.

The G20 should agree to allow the publication of Article IV reports at the same time as they are presented to the Board and the independence of Fund surveillance should be explicitly endorsed by the Governors of the Fund, with Management being held responsible for overall delivery of analysis based on strategic priorities endorsed by the Governors.

Combatting macroeconomic shocks and supporting sustainable growth

Increased global integration means that countries have to deal with a widening range of macroeconomic shocks which can trigger **sudden stops in capital inflows** or serious current account implications, as highlighted by the current crisis. While a strong policy framework has a key role to play in helping countries increase their robustness in the face of such shocks, there will also be circumstances when a country needs to call on foreign exchange and other resources from the international community to smooth the impact of a temporary shock, or gain breathing space to put in place an optimal adjustment strategy for the longer term.

Building up precautionary national reserve holdings is one approach to meeting this need, which some countries have increasingly relied upon. It has certain benefits - flexibility, independence and speed. But very large holdings can lead to substantial sterilisation costs, lost opportunities for domestic investment and a distortion in the allocation of resources. Moreover, if many countries attempt to follow this strategy, and use current account surpluses to build their foreign exchange reserves, the effect will be to underpin international imbalances with

serious long-term costs.

There is a significant risk that the global crisis could result in some countries seeking to rely even more on building precautionary national reserves. The international community therefore needs to act quickly to provide **credible alternatives**. These need to:

- make resources available on a sufficiently **large scale** to deal with global shocks;
- be available **quickly**;
- be available with sufficient **certainty** that countries and financial markets can rely on the funds being there when needed; and
- be available in a way that reinforces positive market perceptions of economic policy and without the **political fallout** currently associated in some countries with the use of existing IMF instruments.

One approach would be to try and develop new premium-based **multilateral insurance arrangements**, independent of the IMF, and specifically focused on helping countries insure against capital market shocks. But these cannot viably meet the needs of large countries or respond effectively to synchronised shocks across many countries such as the one we have just experienced. Alternative approaches are therefore needed.

One approach is to look at developing the **financial facilities of the IFIs** themselves, especially the IMF. These were established to provide fast disbursing finance from the official sector to maintain national and international economic stability, yet the current crisis has exposed weaknesses in the effectiveness of these instruments. Reforms to IMF governance are likely to be one of the most effective ways to achieve greater acceptability for these facilities. The new Flexible Credit Line has been an extremely valuable addition to the Fund's toolkit. This success needs to be built on to further enhance its ability to substitute for precautionary reserves.

The Fund should increase the certainty of access to the FCL by making confidential assessment of eligibility, up to a certain level, a systematic part of the surveillance process, for example in conjunction with the Article IV process.

The cost of accessing the FCL should be reduced to make the facility more attractive compared to other forms of liquid finance.

As well as ensuring countries have access to a sufficient **quantity** of finance in the event of a crisis, it is also important that there should be sufficient **flexibility** in the way it can be used. The parameters of what the IMF can/cannot do should be clearly established.

Regional and bilateral reserve pooling arrangements can also play a significant role in supporting countries facing capital account shocks. They can make more efficient use of existing national precautionary reserves and help avoid problems created by the reluctance of some countries to access IMF borrowing. They cannot substitute for the IMF, but they can supplement and complement the IMF's global role as a provider of support.

The G20 should establish an expert working group on capital account crises to:

- **examine the modalities for the Fund to provide fiscal - as well as balance of payments – financing and develop options for Finance Ministers to consider;**
- **assess the lessons learned from the use of bilateral swap lines in the crisis;**
- **develop a framework of principles which would set out how bilateral, regional and global financial arrangements (including those provided by the IMF) can work more effectively together in the future.**
- **The working group should report to the G20 by April 2010.**

The crisis has also revealed a greater need for **fast disbursing finance to meet investment** needs (particularly infrastructure financing) in middle income countries and other developing economies in the event of sudden stops in capital inflows. The World Bank and Multilateral Development Banks (MDBs) have responded well to the crisis, but it is necessary to consider how this response may be sustained and strengthened. As well as consideration of capital resources, there is a strong case for multilateral institutions to act more decisively in response to shortfalls of this kind. More aggressive use of the Banks' balance sheets would significantly expand the financing available to sustain recovery from crisis.

Alongside consideration of resources, reforms should also be made to increase the World Bank's legitimacy, relevance and effectiveness, including: to the distribution of voting power and decision-making between its members; to how the Bank's strategy is formulated; to how the Bank's President and senior management are selected and held accountable for their performance; and to the division of labour between the Governors, Board and Management. Improvements in the Bank's governance structures coupled with better operational effectiveness and stronger partnership working would give shareholders greater confidence that resources provided to and through the Bank will reduce poverty and foster sustainable growth.

The G20 should call on the World Bank and other MDBs to:

- **ensure they are adequately capitalised to meet future needs, including reviewing whether further General Capital Increases are needed. These reviews must be accompanied by rapid progress on governance, accountability and operational effectiveness and be completed by Spring 2010;**
- **make greater use of guarantees as proven countercyclical instruments and an efficient way to use capital; and,**

- **put in place a pre-agreed framework for temporarily raising leverage ratios and accessing additional callable capital in the event of global crises and sudden stops.**

Meeting the development challenge in times of global crisis

The global economic crisis has affected every country in the world but the poorest countries and their people have been most severely hit, despite having no responsibility for the origins of the global shock. Global levels of income poverty have increased and progress made towards the other Millennium Development Goals (MDGs) has been reversed.

The crisis has shown that the international mechanisms for sustaining progress to the MDGs in the face of global shocks need to be strengthened. The system for providing concessional finance needs to be larger and more flexible. Steps have already been taken by the G20 and the IFIs at the London Summit to support countries' development objectives in the face of the crisis but more needs to be done. Supporting sustainable and stable global growth is a prerequisite for attaining the MDGs.

The G20 should:

- **call on the Fund to undertake a systematic analysis of its lending to low-income countries to assess whether current resources are adequate to meet potential demands from low income countries overall and are appropriately scaled to the needs of individual countries;**
- **encourage countries to lend a proportion of their Special Drawing Rights (SDRs) to ensure that the Fund has the capital resources it needs to support lending to low income countries (LICs); and,**
- **agree the establishment of a crisis response facility in IDA to fund critical development expenditures, including safety nets, in times of crisis without tying up scarce development resources in advance of need.**

To increase the robustness of LIC and other developing economies to shocks in the long-term the G20 should also stimulate new sources of investment in normal times. One approach, which would also have the benefit of **facilitating enhanced deployment of existing national foreign exchange reserves**, is to establish a new fund to catalyse infrastructure investment in LICs and other developing countries. This would leverage MDB expertise in project development and influence with recipient governments. It would also help to channel finance from institutional investors, particularly Sovereign Wealth Funds (SWFs), to LICs and other developing countries with a long-term need for investment funds in infrastructure and other capital projects. The fund would provide a buffer between the investment destination and the investor, facilitating foreign investment in certain areas that might otherwise be ruled out by concern over foreign control of strategic national assets.

The G20 should call on the World Bank to develop with institutional investors a privately financed 'Fund of Funds' for SWFs and others, facilitating investment in infrastructure in LICs and other developing countries.

Low income and other developing countries are among those most vulnerable to the effects of climate change. Significant increases in **public and private finance**, including through a strong role for the global carbon market, are urgently needed to support the implementation of ambitious, country-led climate adaptation and mitigation strategies in developing countries, according to the principle of common but differentiated responsibilities and respective capabilities.

The financial architecture post-2012 will need to underpin this finance with new institutional arrangements that: are representative of developed and developing countries; ensure strong financial management and coherence between instruments; and guarantee the provision of finance quickly and at scale in support of country-led climate strategies, with a greater focus on supporting programmes as well as projects.

In these arrangements:

- the World Bank and the Multilateral Development Banks should have an important role; supporting developing countries in the preparation of integrated climate and development strategies; filling a critical fiduciary role in international climate finance; and managing the delivery of key finance streams; and,
- a new high-level body that is fair, efficient and representative should be established to assess and provide guidance on needs and sources of funding, and to ensure that finance is allocated according to the most pressing instruments and needs.

CHAPTER 1: A GLOBAL COMPACT FOR GROWTH AND STABILITY

- 1.1. The development of the international economy over the last two decades and the recent crisis has strengthened the case for stronger and more systematic international coordination, of structural, macroeconomic and financial regulatory policies. Globalisation has increased the interdependence of national economies and the potential for spillovers, particularly cross-border capital flows, as well as the increased interconnectedness of financial systems. In responding to the crisis the G20 has demonstrated the potential gains from greater policy consistency.
- 1.2. The priority is now to continue supporting jobs and the move to long-term strong and more balanced growth. To achieve this, G20 Leaders must now learn the lessons of the crisis and build on the structures for cooperation and coordination that have been established over the past year to manage the pressures and risks of globalisation.
- 1.3. The lesson of the past is that to be effective these structures need to be grounded in political consensus at the highest level and a recognition that it is in countries' own interests to work together to enable the world economy to achieve high levels of growth without developing dangerous vulnerabilities.
- 1.4. This report proposes a global compact for growth and stability with structures for cooperation and coordination to achieve this shared objective. It goes on to set out ways to modernise the roles of the IFIs and improve their effectiveness in supporting all countries in the world in meeting the new challenges of globalisation and facilitating effective international economic co-ordination.

Recent Global Growth and the Case for Economic Policy Coordination

- 1.5. The global economy has grown rapidly over the past twenty years, with real incomes globally rising by 40 per cent since 1994. This rapid world growth was built on three foundations:
 - First, the **globalisation of flows**. World trade grew faster than overall economic activity in virtually every year, averaging about 6 per cent annual growth in recent years. International capital flows more than tripled, with truly global financial institutions at the centre of the global capital markets
 - Second, the **greater integration of Emerging Market Economies**, especially China, India and Eastern Europe, into the global economy leading to a doubling of the available global labour force and rapid increase in global potential output. The consequent downward pressure on prices of traded goods reduced inflationary pressures in developed economies, allowing them to maintain low interest rates and hence continue expansion in domestic demand.
 - Finally, **technological change**, in particular improvements in the use of information and communication technology, boosted productivity growth and hence the trend growth rate.
- 1.6. However, it is now clear that the global mix of macroeconomic, and structural policies, particularly financial, before the crisis created instabilities and did not always support balanced growth.

1.7. Market infrastructure necessary to support this globalisation lagged behind growth. In particular, both international and national regulation failed to keep pace with both the magnitude and complexity of global financial flows. In financial markets, financial innovation outpaced risk management of financial institutions, regulatory bodies and the international institutions. As a result, excessive leverage and risk-taking followed, with capital flowing into poorly regulated financial instruments. The increased interconnectedness of the global financial system ensured that bubbles in financial assets at a national level – and their subsequent collapse - had a very strong international impact.

1.8. The welcome improvement in global living standards was also underpinned by an uneven pattern of growth, reflecting differences in the composition of demand and supply amongst countries. One consequence of this uneven growth was large current account imbalances. And, in part linked to this, foreign exchange reserves (mainly held in dollars) rose in surplus countries. Official foreign exchange holdings rose from about \$2 trillion in 2000 to about \$6.7 trillion in 2008, with 60 per cent of reserves held in dollars, as surplus emerging market economies invested in the largest, safest most liquid markets – advanced economy government bonds, particularly US treasuries. Whether or not these imbalances played a direct role in causing the financial crisis, the abrupt correction that followed has highlighted how they increase the vulnerability of both the global economy and individual national economies. While imbalances can build up slowly over time, their unwinding can be both sudden and damaging.

1.9. Other factors reduced potential growth and arguably, by hindering potential adjustment mechanisms, allowed the global economy to overheat. These included inefficient commodity markets. Here the supply response to price signals was inhibited by lack of transparency about future trends in supply and demand, exacerbated by lack of commercial approaches to investment in

some countries. Also, tariff and non-tariff barriers, capital controls and currencies that were not fully convertible also prevented efficient adjustment in the global economy. Despite efforts in numerous rounds of trade talks, progress in removing trade restrictions was painfully slow.

1.10. Cumulatively, these factors reduced the sustainable growth potential of the world economy. To return the world economy to the high levels of growth experienced before the crisis, but on a sustainable and more balanced basis, the G20 will together need better co-ordination of macroeconomic policies to rebalance the sources of global demand; and of structural reforms, particularly financial, to raise the trend rate of global growth.

G20 Leaders should agree on the following overarching principles to manage globalisation and guide their policies in delivering the future global economy, consistent with the proposed Charter for Sustainable Economic Activity:

- **financial systems based on responsibility, transparency and integrity - that serve the needs of families and businesses;**
- **sound macroeconomic and structural policies, particularly financial, to deliver high, sustainable and more balanced global growth;**
- **open economies without harmful protectionism;**
- **environmentally sustainable production and consumption to accelerate the transition to a low carbon economy; and,**
- **a fair distribution of the benefits of growth between and within countries.**

Implementing Future Coordination

- 1.11. The need for improved international economic coordination has been well established for many years. Since the breakdown of the Bretton Woods system coordination has been sporadic and generally focused on exchange rate misalignments as it was in the case of the G7's Plaza and Louvre accords. With capital markets less developed and central banks still operating with multiple objectives, macroeconomic coordination could at times be effective in helping to balance the global economy.
- 1.12. More recently, the financial and economic crisis revealed the full extent to which globalisation has led to the true interdependence of national economies. In today's world of global capital flows macroeconomic coordination must be accompanied by structural reform, including in relation to the financial sector and its regulation, to ensure that economies can respond flexibly to economic fundamentals. In the last decade, the need for coordinated action has been well understood, but countries have lacked both the political will to fully engage on these issues and a mechanism through which to take the action required to address risks and vulnerabilities in the global system.
- 1.13. In responding to the crisis the G20 has demonstrated that they have the political will, and that unprecedented levels of cooperation and coordination can make a real difference. The decisive and concerted actions agreed at the Washington and London Summits have helped to stabilise financial markets and improve the outlook for the global economy. These include expansionary fiscal and monetary policies, financial support measures and our commitment to deliver a \$1.1 trillion programme of international financial support to restore credit, growth and jobs in the world economy – and globally coordinated action to reform financial regulation. The ILO estimates, on the basis of IMF calculations, that the G20 fiscal expansion will have created or saved between 7 and 11 million jobs in the G20 countries in 2009.
- 1.14. The priority is now to continue supporting jobs and the move to long-term strong and more balanced growth. To achieve this, we will need to learn the lessons of the crisis. The G20 should now take the opportunity to build on the structures for cooperation and coordination that have been established over the past year to prevent future crises and to manage the pressures and reap the benefits of globalisation.
- 1.15. Global demand must be sustained in the short term by:
- **fully implementing fiscal, monetary and financial support commitments.** This is to ensure that policy continues to support economic activity until recovery is secured.
 - **coordinating the unwinding of extraordinary support measures once the recovery is secured in a coherent and consistent way.** The unwinding must not prejudice a return to sustained growth or undermine public or market confidence in policymakers' determination to ensure a durable recovery.
- 1.16. However, securing high, sustainable and more balanced growth can only be achieved over the long-term by:
- **ensuring that the necessary macroeconomic adjustment takes place in an orderly manner.** The global economy is facing the difficult task of rebalancing. The crisis and the crisis response measures have already produced significant shifts in the pattern and level of demand growth but achieving high levels of sustainable, more balanced growth is likely to be a longer process;
 - **removing the domestic barriers to growth** - the structural factors which generated large current account imbalances and prevented adjustment of economies to the underlying fundamentals must

be targeted through consistent domestic structural reform policies. Structural reform at a domestic level, by all G20 countries, will have a global impact.

- **promoting the efficient functioning of global markets - both internationally and domestically.** To ensure the world economy realises its full potential international action is required across a range of markets, including financial markets, labour markets and commodity markets, to release the full potential of globalisation.
- **identifying and addressing systemic risks, particularly those arising in the financial sector.** A well-functioning and internationally integrated financial sector will be more important than ever to maintain high and sustainable global growth and will be vital for channelling savings to profitable investments in developing and emerging market economies. However, the events of the last year have re-emphasised to manage the associated risks in such a system effectively.

1.17. Delivery of these objectives would support global growth today and put in place the conditions to support high, sustainable and more balanced growth over the long term. It is very much in the interests of individual countries, and in the global collective interest, to intensify international coordination and cooperation. As set out in Box 1, the IMF estimates that the difference between strongly and weakly coordinated G20 macroeconomic and structural policy actions, could add up to 2¼ per cent a year over the medium-term – close to \$6 trillion in total at the end of 5 years – over a tenth of annual world output.

Box 1 - The gains from coordination – growth, stability and jobs

Simulation analysis prepared for the G20 by the International Monetary Fund demonstrates the large benefits for all the major economies that would result from coordinated policies designed to entrench and sustain recovery; and the damage that would result from the lack of strong policy action and a failure to coordinate. The IMF examines two scenarios:

- In the positive scenario, successful and well-targeted policies lead to higher growth and a more sustainable distribution of demand. Demand is higher and saving lower in surplus countries; successful repair of the financial system allows productivity growth to rise; and government spending on “green” and infrastructure projects rises substantially.
- By contrast, in the downside scenario, delays in repairing the financial sector and protectionism inhibit productivity growth, while imbalances widen, and fiscal deficits increase because of lower growth. The consequence is that the world economy falls back into recession before recovering only slowly.

The difference between the two scenarios – illustrating the difference between successful coordination and the reverse – is dramatic. Under the positive scenario, world GDP growth is about 1 per cent higher than the baseline, averaging a robust 5 per cent; in the downside scenario, it is 1¼ per cent less than the baseline. The result is that by the end of 2014, output is fully 11 per cent, or \$6 trillion, higher in the positive scenario.

This would have a dramatic impact on jobs and fiscal deficits. The IMF estimates imply that labour input would be 6 per cent higher in the positive scenario than in the downside one – based on ILO estimates of the world’s labour force that could mean up to 200 million extra jobs. It is difficult to imagine a more dramatic illustration of the potential benefits from international economic cooperation.

Moreover, such coordination could also make a major contribution to putting advanced economies on the road back to clear medium - term fiscal sustainability. Debt ratios would be much lower – in the euro area, for example, by well over 10 per cent of GDP – in the positive scenario.

A global compact for growth and stability

1.18. To underpin this cooperation, the G20 should agree a new global compact for growth and stability, demonstrate a common commitment to take the required action and send a powerful signal that they have a vision for the future of the world economy.

The compact should have three central objectives:

- first, the G20 must make every effort to support the recovery and plan coordinated exit strategies from current expansionary measures to make sure the recovery is not put at risk;
- second, the G20 must agree how each of us over the medium term can best contribute to worldwide growth, to benefit jobs in all our countries, and ensure that this growth is more balanced and sustainable, while maintaining long term fiscal sustainability; and,
- third, the G20 must reform and strengthen the governance and regulation of what is now a global financial sector.

1.19. To be effective, the compact needs to be based on a strong and enduring political consensus between G20 countries to cooperate in supporting jobs and delivering prosperity for all. G20 Leaders should explicitly recognise that:

- in a highly integrated global economy, it is in every country’s interests to treat their economic policies as a matter of common concern. Concerted policy action may therefore be required to achieve the best outcomes for all;
- national governments are responsible and accountable for economic policy making, and policy coordination must therefore be directed and led by national governments; and,
- policy discussion and, where appropriate, concerted policy action by national governments should be made on the basis of objective, independent analysis and advice.

1.20. To deliver this compact the G20 will need a concrete, country-led framework and new supporting structures that allow it to provide continued political leadership to global economic management. Recent history has shown that we need a structured approach to policy discussion and action between countries, particularly where decisions impacting on fiscal or monetary policy, structural economic reforms, or the financial sector have domestic political repercussions and must be maintained over long time periods.

1.21. The limited impact of attempts to tackle risks in the global economy before the crisis demonstrate that to be successful these need to be grounded in political consensus on objectives, a commitment to deliver outcomes to achieve these objectives and then discussions within a more political forum, supported by the best possible technical analysis.

1.22. Learning from the success of its action to prevent a global depression and rescue the global financial sector, the G20 should build a new supporting structure for cooperation and coordination, based on political decision-making underpinned by economic expertise. The structure will need to be led by G20 countries but will require objective, generally accepted high quality analysis to support the consensus if it is to be successful. The compact would require the following elements to be successful:

i. Common objectives

First, the G20 will need to come to an explicit agreement on common objectives of high, sustainable and more balanced global growth, while maintaining long-term fiscal sustainability. As an initial step the G20 should commit to achieving a global growth rate of around 3 per cent by the end of next year (in line with the IMF's latest forecast).

Objectives would then be refreshed as necessary each year, with the G20 using the global compact to facilitate a return to the high levels of growth

we experienced before the crisis but this time on a sustainable and more balanced basis.

ii. National medium-term policy frameworks

Second, G20 countries should commit to put forward their own medium-term policy frameworks. These frameworks would outline how each country plans to contribute to the G20's common objectives of ensuring high, sustainable and more balanced global growth.

iii. High-quality and objective technical analysis

The G20-led global compact will need to be supported by objective, high quality and generally accepted analysis, to identify specific issues and vulnerabilities in the global economy; to assess the consistency of countries' medium-term frameworks with the agreed common objectives; and if necessary to make suggestions or recommendations as to how inconsistencies might be resolved.

The G20 would need to draw on a wide range of available analysis, most obviously from the IMF in its role as confidential adviser to the G20, working with the FSB on macro-prudential issues, but also from a number of other institutions including e.g. the World Bank, OECD, BIS and ILO.

The IMF, in its role as confidential adviser, would provide regular reports to G20 meetings, privately in the first instance, in the same way that the Fund has provided confidential reports to the G7 for many years and for the G20 more recently.

The IMF should develop a framework to assist the G20 in forecasting economic developments, particularly whether demand, credit, debt and reserve growth patterns, and any other economic variables are supportive of high, sustainable and more balanced global growth.

iv. **High-level political discussion and mutual assessment**

Once national frameworks have been proposed and assessed for consistency by the IMF, and other institutions where necessary, the G20 would then need to mutually assess the national frameworks in light of the Fund's analysis on the global conjuncture and the overall consistency of these frameworks with medium-term common objectives.

Where necessary, the G20 would then need to agree on how to address any risks or vulnerabilities in the global economic and financial systems, and any inconsistencies between their national frameworks and medium-term objectives. This process of multilateral discussion and negotiation, led by the G20, will undoubtedly require judgement and political sensitivity.

The implementation and impact of national frameworks and agreed outcomes against agreed objectives would then be a matter for discussion by the G20 at its subsequent G20 meetings.

v. **Warning mechanisms**

The reports the IMF produces for regular G20 meetings would update on economic conjuncture and the impact and implementation of agreed outcomes against agreed objectives.

However, it will also be necessary to develop ways to provide a more urgent warning to the G20 if progress towards the objectives is at risk of going off track. G20 countries would then be able to call discussions where necessary and agree how to respond and put the global economy back on track.

The Fund should prepare advice for the G20 on the nature and level of quantitative thresholds for the variables that will underpin its detailed and focused reports to the G20.

Learning from the success of its action to prevent a global depression and rescue the global financial sector, the G20 should build a supporting structure for cooperation and coordination, based on political decision-making underpinned by economic expertise. It should be a G20, country-led framework, including the following elements:

- **explicit agreement, regularly assessed, by the G20 on our common objectives of balanced, sustainable and enduring growth;**
- **a commitment by each country to set out its medium-term policy framework, showing how it will contribute to the common objectives;**
- **analysis provided by the IMF on the situation and risks in the world economy, working together with the Financial Stability Board on the interaction of financial and economic risks, drawing on other institutions as needed. This should include analysis of the consistency of our economic plans with our overall objectives for sustainable and balanced global growth;**
- **clear mechanisms to warn us when we are off track to deliver our objectives, so that governments can take decisions on the need for action based on the best possible information; and,**
- **political agreement on the policy actions needed to address any risks and problems.**

G20 Finance Ministers and Central Bank Governors should further develop the supporting process and structures (outlined above) at their next meeting in November in St Andrews and begin implementation, with further development work, as needed, to be taken forward through the Finance Ministers' process.

Reform of the IFIs alongside the global compact

1.23. Agreement of a global compact of this nature would address some of the concerns about the future stability and sustainability of global growth. However, the compact can only be effective if supported by wide ranging reform of the functions and governance of International Financial Institutions. It is particularly important that the IMF's legitimacy is strengthened. Without this it will not be able to act as a confidential and trusted adviser to the whole international community or to remove some of the obstacles that have prevented the full use of its financial facilities in the recent past.

1.24. This reinforces the need for the G20 to deliver on the commitment made at the London Summit to fundamental IFI governance reform as part of which the voice and representation of emerging and developing economies, including the poorest, must be significantly increased to reflect changes in the world economy and the respective mandates of each institution. It will be vital to increase accountability of the IMF and World Bank to member countries, including through a more open, transparent and merit-based selection process for senior management. In addition, it will be critical to ensure a clearer focus on outcomes and accountability through a division of labour between Governors and Management, in particular by strengthening the role of Fund and Bank Governors in strategic oversight and reinforcing the operational effectiveness of IFI management.

1.25. For the IFIs to support the compact effectively in achieving high, stable and sustainable growth there will need to be further key reforms to ensure that:

- **IMF analysis and advice** is independent, credible and relevant and that international financial stability structures (including the **new role filled by the FSB**) are effective in preventing future crises. **Chapter 2** details reforms to achieve this;
- the international financial system is better equipped to assist countries **manage macroeconomic shocks**, reducing the need for precautionary reserves and supporting sustainable growth. **Chapter 3** outlines proposals to meet these needs; and,
- critical **development challenges** are met both during times of crisis and relative stability, including responding to the **challenges of climate change**. Proposals are set out in **Chapter 4** to address these challenges.

CHAPTER 2: PREVENTING FUTURE CRISES

2.1. The aim of the global compact is to improve the process of international economic policy coordination. To achieve its objectives it requires support from the IFIs and a range of other international institutions to provide high quality technical inputs and to support the implementation of agreed policy actions. This is particularly true with respect to the financial sector.

2.2. One of the key lessons of the crisis was that the linkages between the risks that emerged in the financial system and their impact on the global economy were not well understood. Even where they were identified, it proved difficult to agree and take action to address the emerging risks. To support a new system of multilateral cooperation to create high levels of sustainable growth, reform is required to:

- enhance the role of the **Financial Stability Board** to promote a more coherent system of international financial sector regulation and standard setting;
- ensure that the **IMF has clear objectives and appropriate resourced**, building on its core competences, to support global financial stability along side its long-standing remit to promote stability of the international exchange system;
- support more general further enhancements in the conduct of the **IMF's analysis** to strengthen its independence, credibility and focus on multi-country risks.

Strengthening oversight of the global financial sector

2.3. The crisis has powerfully illustrated the need for effective international agreements, underpinned by collaborative approaches and strong international institutions, to ensure long-term global financial stability.

2.4. There is a particular need for new supervisory standards to be developed and implemented speedily. However complex an issue and strong the national interests in different approaches, the international community can no longer afford the lengthy multi-year gestation processes that we saw for Basel I and Basel II agreements on capital ratios. Otherwise, we leave the global financial system open to unacceptable risks and the threat of regulatory arbitrage.

2.5. In response to these concerns, the G20 made important progress at the London Summit to develop further the institutional structures for international co-operation on financial stability - in particular, by developing the mandate and membership of the Financial Stability Board (FSB), and calling for enhanced efforts by the FSB and IMF to monitor systemic financial risks in the global economy.

2.6. But growth in the scale and complexity of the international agenda has become increasingly apparent, as has the urgency of making progress in certain key areas, such as capital adequacy regulation. It is therefore vital that we ensure the capability, resources and influence devoted to the international co-ordination of financial stability efforts keep pace with requirements.

- 2.7. It is also important to recognise that the pace of progress in the past year in part reflected the urgency of the problems the world faced at the height of the crisis and the enormous political attention focussed on the search for solutions. The same degree of political input cannot be guaranteed in future years once the immediate effects of the crisis have receded, and pressures to return to “business as usual” will make internationally agreed regulatory reform more difficult.
- 2.8. To be effective in identifying and tackling the risks to global financial stability, the international system needs to:
- be **properly resourced**, not just for immediate demands, but also to keep pace with likely future demands;
 - have sufficient **authority and influence**, drawing in particular on the support of the G20 Leaders, Finance Ministers and Central Bank Governors. This is particularly important in ensuring that required common regulatory standards at the global level are developed in a timely and efficient manner
 - follow the principle of **subsidiarity**, so that international bodies only do those things that are not being done, or cannot be done effectively, at national level;
 - ensure that regulatory **underlaps and overlaps** between organisations are actively managed, so that we do not inadvertently allow “holes” or inconsistencies in the regulatory system;
 - ensure key contributors to the international structure (particularly the IMF and FSB) but also other expert institutions (such as the World Bank, OECD, BIS, FATF and WTO) are clear about their respective **roles and objectives** and how they relate to each other.

The G20 should adopt these principles to underpin future steps to reform and develop international financial stability structures.

Strengthening the Financial Stability Board (FSB)

- 2.9. At the London Summit in April this year, G20 Leaders agreed that the Financial Stability Forum (FSF) should be expanded, given a broadened mandate to lead and promote work on financial stability, and re-established with a stronger institutional basis and enhanced capacity as the Financial Stability Board (FSB). This reflected a clear consensus that global regulatory structures had to operate in a different way in future in order to prevent a recurrence of the crisis.
- 2.10. The FSB is responsible for micro-prudential policy, leading and co-ordinating the development of international regulatory standards and systems for responding to institutions in crisis. It also shares responsibility with the IMF for work on macro-prudential policy and risks. A new mandate for the FSB is in the process of being approved.
- 2.11. Significant progress has been made since London. The FSB has set up the internal structures needed to address its mandate, including a Steering Committee and three Standing Committees. It has also established a Cross-border Crisis Management Working Group, and an Expert Group on non-cooperative jurisdictions. However, the demands on the FSB continue to grow rapidly, emphasising the need for strong political authority, a clear charter, an enhanced relationship with standard setting bodies (SSBs) and assurance of adequate resources.

Box 2 - Strengthening the FSB

The high profile role of many of the issues dealt with by the FSB highlights the need for there to be proper accountability to appropriate political authorities, while ensuring that the critical role of independent technical experts in national authorities, on the Board itself, and in supporting working groups is preserved. The FSB has supported the G20 in achieving its objectives over the past year and has benefited from the G20's leadership. It is vital that the governance of the FSB is effective and builds on this established relationship.

The FSB's relationship with Leaders, G20 Finance Ministers and Central Bank Governors should be formalised. As one element of this, the FSB Chairman should report on the implementation of the G20 programme for regulatory reform, its activities and future work plan (with resource implications) to the G20. FSB reports should be a standing part of G20 Finance Ministers and Central Bank Governors' meetings, starting with their first meeting in 2010.

The FSB's relationship with standard setting bodies (SSBs) is crucial to the overall functioning of the global regulatory system. These bodies are highly diverse, with different histories, varying degrees of independence, different constitutions and memberships, and different degrees of public and private sector participation.

While it is clearly right that standards themselves should be developed by those with the expertise and direct authority over intermediaries, there is also a risk that without clearly defined roles and responsibilities and proper accountability mechanisms, the delivery of standards could be compromised,

particularly when political attention has lessened. The FSB should not have the power to interfere with the standard setting process itself, but should be in a position to hold the SSBs to account for delivery and report back to G20 Finance Ministers and Central Bank Governors if problems emerge.

To ensure stronger overview and coordination of the SSBs, the FSB should agree an MOU with each SSB, setting out clearly roles and responsibilities, and steps to be taken by the FSB, including reporting to the G20 on problems preventing the delivery of the required standard within the necessary timeframe.

The FSB is still not adequately resourced. Even after the expansion earlier this year, the FSB still only has a very small number of permanent staff. These staff are clearly under considerable pressure to keep up with the rapidly growing demands on the institution.

To ensure that the FSB is adequately resourced and has the capacity to keep pace with growing demands, the G20 should call on the chair of the FSB to develop a medium-term business plan, identifying expected resource requirements and financing arrangements over a 3-year time frame. This should be shared with G20 Finance Ministers and Central Bank Governors at their next meeting in November.

The IMF and financial stability

2.12. The IMF has a central role in the promotion of financial stability, working with the FSB and other international organizations. This reflects far reaching changes to the global economy (particularly the growth in volatile capital flows) that have been accompanied by a series of increasingly serious shocks linked to financial crises. While the role of the FSB is focussed on micro-prudential issues and standard setting as well as aspects of macro-prudential oversight, the focus of the IMF is on the macro prudential, including such issues as:

- analysis of global **interactions** between macroeconomic policy and financial stability;
- providing analysis, e.g. through the FSAP process, designed to reveal **macro-prudential weaknesses** in country financial systems;
- and provision of **financial facilities** to help countries adjust to financial market shocks (including capital flight).

2.13. In the latter context there has been an active debate on whether the IMF has the appropriate facilities to respond to the needs of countries which face external capital market shocks which impact on their financial systems. One question is whether the requirement for the IMF to link all assistance to a balance of payments need is unnecessarily constraining (see Chapter 3).

2.14. At the same time the formal basis for the IMF's role in financial stability, particularly in the area of surveillance has been slow to evolve, though there has been change in practice (see Box 3).

Box 3 - History of IMF surveillance and financial stability

The IMF was founded to overcome the coordination failures of the 1930s that led to protectionism and competitive devaluation and exacerbated the impact of the Great Depression on global living standards. The purposes set out in the Fund's Articles of Agreement identify the growth of trade, supported by a 'stable system of exchange' as the motor for rising global prosperity. The policy instrument used to achieve this stability was initially the Bretton Woods system of fixed, but adjustable, exchange rates. The rules that supported this system gave a strong quasi-legal incentive to policy cooperation. It also provided a clear intermediate objective to measure whether countries were cooperating effectively.

This system was appropriate for a period when capital accounts were mostly closed and global integration – even in trade - relatively limited. As the integration of the global economy increased and the pace of change accelerated, the role of the IMF in promoting policy cooperation also changed. The objective of a stable system of exchange could no longer be translated into the easily observed outcomes of stable bilateral exchange rates.

With countries free to choose their own exchange rate regimes and conduct domestic policy in the light of that exchange rate choice, the Fund's surveillance function has become one of its most important policy instruments.

The foundation of IMF surveillance is set out in Article IV of the Fund's Articles of Agreement. It places the responsibility for overseeing the effectiveness of the international monetary system on the Fund and requires each

member to 'collaborate with the Fund and other members to assure orderly exchange arrangements'. This formal mandate has ensured that exchange rates have been at the centre of Fund surveillance. However, as the Governor of the Bank of England, Mervyn King, said in 2006:

'...no one price is a sufficient statistic for the effect of one country's policies on the rest of the world - even one as important as the exchange rate.'

This conclusion has been reinforced by the economic and financial crisis. Neither transmission mechanisms through which shocks pass from one economy to another, nor the interaction of macroeconomic and financial shocks, are well understood. The crisis has shown that financial sector shocks are capable of creating international economic instability even when the system of exchange the IMF was designed to support is stable. This shows that a system designed to avoid competitive devaluation alone does not provide sufficient support for global economic stability.

Despite the deep changes to the global economy in the last generation, the formal basis on which IMF surveillance is founded has at times been slow to evolve. The basis in the IMF's articles has remained unchanged since the Second Amendment to the Articles of Agreement came into effect in 1978. Although recent Board decisions (e.g. the statement of surveillance priorities) have developed this.

- 2.15. To ensure sufficient prioritisation for the financial stability aspects of the IMF's work over the long term, an appropriate allocation of resources and management time, as well as a further strengthening of the close working relationships with other international institutions, particularly the FSB, the IMF should further develop and define its role in support of financial stability.

The IMF should examine whether its is adequately equipped to take on its role in financial stability as described above, with a view to ensuring sufficient prioritisation, an appropriate allocation of resources and management time, as well as a further strengthening of the close working relationships with other international institutions, particularly the FSB. A report should be presented to IMF Governors by April 2010.

Strengthening the IMF's global surveillance

- 2.16. As well as developing the IMF's role in relation to the compact and on financial stability, other reforms are appropriate to strengthen the ability of the IMF to support the international community in maintaining global growth.
- 2.17. A key aspect of the IMF lies in its ability to take a broad overview of developments in a number of countries and to provide a multi-country perspective to its analysis. This is consistent with the overall objective of ensuring systemic stability. In an increasingly integrated global economy all of its members need to take decisions about policy in the light of both other countries policy decisions and their interaction. However, the institutional structures for Fund surveillance are currently anchored on individual countries and bilateral dialogues.

- 2.18. Moving to a system which placed more emphasis on global and regional surveillance rather than single country analysis would have a number of advantages by:
- Ensuring that multi-country surveillance was more than simply the sum of all single-country surveillance products, bringing a genuinely different perspective;
 - Exploiting the IMF's unique comparative advantage as a universal institution;
 - Increasing the credibility and effectiveness of policy advice since frequently addressing international risks requires coordinated actions not easily set out in a bilateral context.
- 2.19. To achieve this multi-country perspective, a new system should be designed in which multi-country surveillance at the global or regional level complements the present bilateral Article IV arrangements. The aim is to strengthen surveillance especially of the systemically important issues and not lessen the specific assessment of the contribution of each country individually to global economic stability.
- 2.20. Within the Fund, organisational changes should be made to strengthen the multilateral focus of surveillance. Currently, there is no single point of responsibility within the Fund for multilateral surveillance. As a result, the Fund's major and high quality surveillance products (the Global Financial Stability Report and the World Economic Outlook) are produced largely independently. A single, unified product produced within a global surveillance department would fulfil both the objective of bringing together financial and macroeconomic analysis and present comprehensively the full range of risks in the global economy to policymakers.

The Fund should:

- **move to a system that places more emphasis on global and regional surveillance and less on bilateral surveillance; and,**
- **by April 2010, establish a new global surveillance department to unify global financial and macroeconomic surveillance products.**

Enhancing the independence of Fund surveillance

- 2.21. In addition to improving the basis of surveillance so that it is technically accurate, correctly focussed and appropriately presented, the Fund must be empowered and equipped to present views independent of the reality or perception of political interference. Only then will it be seen as the provider of balanced and objective advice.
- 2.22. Two additional steps should be taken to ensure that independence, and equally important, the perception of independence, is not compromised.
- 2.23. The first is for the G20 to allow the publication of Article IV reports before they are discussed by the Board. This will ensure that Staff views are presented in full in the public domains. This transparency would deal directly with concerns that the Board exercised undue influence over the content of surveillance reports while retaining the valuable inputs provided by Board discussions. This transparency would also be an incentive to excellence in analysis as it would be subject to greater external scrutiny.

The G20 should agree to take the necessary steps to ensure that Article IV reports are published at the same time as presentation to the Board.

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- 2.24. The second step is to build on the Statement of Surveillance Priorities in October 2008. This provided a framework through which to assess the performance of the Managing Director and Staff in delivering their surveillance objectives throughout the three-year period covered by the objectives. However, the division of responsibility between members and management of the Fund can usefully be made even clearer, with a strengthening of the requirements on both.
- 2.25. Instead of the current approach in which the Executive Board sets the objectives for surveillance, the IMF should gain the direct political commitment to the objectives by the Governors of the Fund, either directly, or through the IMFC. This high level approval could be accompanied by an explicit regular renewed endorsement by members of the need for Fund independence.
- 2.26. The Board would retain the important responsibility for ensuring that Management conducted surveillance consistent with the strategic direction set by Ministers. This would mean periodic review of the conduct and quality of surveillance. But it would remove the need for the Board to discuss each Article IV report.

The G20 should call on the IMF to institute a process through which members of the Fund provide strategic political direction to the IMF through Ministerial approval of the Fund's Statement of Surveillance Priorities and explicit assurances of respect for the IMF's independence.

- 2.27. For the Fund to be a trusted, independent and objective adviser requires all countries have confidence in the legitimacy of the Fund. Fundamental governance reform is required to ensure that all countries have confidence in the even-handedness of the Fund and in the conduct of its business. In this – as in other areas – timely delivery of the G20's commitments to governance reform is essential.

CHAPTER 3: COMBATTING MACROECONOMIC SHOCKS AND SUPPORTING SUSTAINABLE GROWTH

- 3.1. Increased global integration means that countries have to deal with a widening range of macroeconomic shocks that can trigger **sudden stops in capital inflows** or serious economic implications, as highlighted by the current crisis.
- 3.2. Previous crises have shown the very serious damage that can be done to national and international prosperity by capital account crises. In the Asian crisis, it took nearly a decade in many of the affected countries for GDP per head to reach pre-crisis levels. Social indicators also worsened significantly – with poverty doubling in Indonesia alone. In a global crisis such costs in lost output, unemployment and lost human potential are multiplied.
- 3.3. This recent crisis has also shown that macroeconomic shocks transmitted through the current and capital accounts and the financial system have the capacity adversely to affect even countries with fundamentally sound policy frameworks. And so, while a strong policy framework has a key role to play in helping countries increase their general robustness in the face of shocks, a country may not be able to rely on this alone. There will also be circumstances when a country needs to call on foreign exchange and other resources from the international community to smooth the impact of a temporary shock, or gain breathing space to put in place an optimal adjustment strategy for the longer term.

Precautionary national reserves as a hedging mechanism

- 3.4. Building up national reserve holdings is one approach to meeting this precautionary need, which some countries have increasingly relied upon. It has certain benefits - flexibility, independence and speed. But very large holdings can lead to costs at both the individual country level and for the world economy as a whole. And movements in the size of reserves can themselves become a driver of market pressures.
- 3.5. For an individual country with very large reserve holdings, there are fiscal costs associated with sterilisation and the issuance of domestic debt when domestic interest rates are higher than the returns on externally held assets. Perhaps more importantly there is also an opportunity cost of holding reserves. Large reserve holdings mean that resources, which could otherwise have been invested domestically, are invested abroad, typically in the most liquid sovereign instruments, thus distorting the allocation of resources.
- 3.6. There are also costs to the international community. First, global growth, income levels and employment, now and in the future are lower than they would be if the resources were invested more optimally. Secondly, the counterpart of reserve accumulation is the global imbalances. The need to build up reserves provides countries with an incentive to run persistent current account surpluses. This can lead to the build up dangerous imbalances, which can pose a risk to the world economy. The abrupt and

disorderly correction of such imbalances has been a key driver of the current global recession and the collapse of world trade.

- 3.7. A further concern is that many countries, including those that have not hitherto had large reserves, will draw the lesson from the recent global crisis that they should quickly build up precautionary reserves. This would further reduce demand in the world economy. The international community therefore needs to act quickly to provide credible alternatives.

Alternatives to national foreign exchange reserves

- 3.8. The global crisis showed that the existing alternatives to national reserves for countries facing macroeconomic shocks need urgent improvement, with particular weaknesses vis-à-vis adverse capital account movements.

- 3.9. The relative lack of fast disbursing official finance in the crisis reflected a combination of factors, which had inhibited countries from previously arranging contingent facilities. These included: lack of available resources (especially in the IMF); lack of appropriately designed instruments; concern over market signals that the use of official finance might send; and concern in some countries over the domestic political implications of using IMF facilities.

- 3.10. To be credible for the individual country, an alternative mechanism to national reserves needs to:

- make resources available on a sufficiently **large scale** to deal with global shocks;
- be available **quickly**;
- be available with sufficient **certainty** that countries and financial markets can rely on the funds being there when needed; and
- be available in a way that does not generate **negative market or political perceptions**.

- 3.11. In addition, from the international community's perspective it is important that any alternative to national reserves should adequately address moral hazard concerns and re-enforce the incentives for adoption of sound economic policies at the national and global level.

Possible approaches considered in the Review include:

- multilateral insurance arrangements;
- further development of IMF facilities;
- greater integration of regional and bilateral financing arrangements with the work of the IMF;
- development of MDB capacity and facilities to deal with sudden stops in capital inflows.

Multilateral insurance arrangements

- 3.12. One approach is to try and develop new premium-based multilateral insurance arrangements, independent of the IMF, and specifically focused on helping countries insure against capital market shocks.

- 3.13. This would mean, for example, establishing a multilateral pool as a mutual reserve fund where policyholders have an ownership stake in the organisation. Countries would pay a premium during normal times in exchange for a guaranteed pay out during times of turmoil. The size of the premium would reflect the assessment of the strength of a country's economic policies.

- 3.14. However, there are many challenges with developing such an approach. These include the size of the initial capitalisation of such a multilateral pool, the risks to members, the definition of the events being insured against, and the limited ability of any pool to provide insurance for large countries, or respond effectively to synchronised shocks across many countries such as the one we have just experienced. It is therefore necessary to examine other approaches.

Development of IMF facilities

- 3.15. The purposes of the International Monetary Fund set out in the first of the Articles of Agreement stresses that the '...general resources of the Fund should be made temporarily available to members under adequate safeguards, thus providing the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.' It is the final part of this remit that should guide the approach today.
- 3.16. The IMF has had a relatively narrow role as the supplier of finance to countries in the event of external shocks. This has seen the Fund supply finance mainly to support balance of payments only after a need has become apparent. These programmes have assumed that countries with financial needs from the Fund also need to make policy adjustments to correct the imbalances in their economy to bring the external sector of the economy back to a sustainable position.
- 3.17. There remains a role for this approach to lending. Indeed, in the current crisis many countries have borrowed from the Fund and recognised the need for this to be complemented by policy action to bring national economies back into equilibrium.
- 3.18. However, as discussed above, the exceptional conditions of the past two years in the global economy have shown that countries may be exposed to damage from external shocks, especially transmitted through the capital account, even when policy frameworks are fundamentally sound. Also, the effort to balance the concerns of lending and borrowing members tended to create rigidities in the provision of appropriately designed facilities. As a result Fund finance has tended to be available too slowly and in insufficient volumes.
- 3.19. The Fund and its members have already taken steps to respond to this experience and facilitate higher levels of finance, more quickly, and on the basis of an assessment of existing (not modified) policies. The resources made available through both the Flexible Credit Line (FCL) and the High Access Precautionary Arrangements are designed to meet members' needs for sufficient rapidly disbursing funds in the face of continued pressures from the global economy.
- 3.20. The FCL represents a major step forward in the Fund's toolkit with commitments under the facility to Colombia, Poland and Mexico amounting to \$78 billion already approved. Market reaction to these three facilities has been positive, and it is to be hoped that this will further boost the instrument's attractiveness in the future. The willingness of members to contribute additional substantial new resources to the Fund has also given this instrument greater credibility. However, countries may remain concerned that markets will read borrowing from the IMF (even through an FCL) as a sign of having run out of options, thereby exacerbating liquidity pressures. There will also be continuing concern in some countries over the domestic political impact of being seen to rely on IMF finance.
- 3.21. It is therefore critically important to keep building on this success. Reform of IMF governance is one of the most powerful routes to achieve this. As long as Fund governance is not seen as legitimate in the eyes of many members, it is difficult for the IMF to fulfil its role in support of all its members. Addressing these concerns will go a significant way to removing some of the reluctance associated with using the FCL and other IMF facilities.
- 3.22. In addition, there are two technical reforms that could immediately increase the FCL's attractiveness and accelerate its acceptance among a wider range of fund members as an alternative to precautionary reserves (the more countries that use it, the less the risk of negative market signals). The first is to establish a system under which countries are automatically evaluated on their eligibility for the FCL, up to a given financial limit. This would be done confidentially by the Fund, to avoid

any adverse market reaction, and would allow countries to have known access to a predefined level of resources in the event of a crisis. It could also significantly increase the number of countries making use of the FCL. Second, the pricing of the instrument, once drawn down, should be made more attractive.

The G20 should call on the IMF to:

increase the certainty of access to precautionary finance by making the assessment of FCL a systematic part of the surveillance process. Eligibility up to a certain funding range should be assessed regularly and confidentially for all countries, for example in conjunction with the Article IV process. Pre-qualification to higher levels (including the uncapped option in the present FCL) could then be achieved through a further Board approval process (as now); and,

reduce the cost of accessing the FCL to make the facility more attractive compared to other forms of liquid finance, for example to exchange of Special Drawing Rights for hard currency.

consistent with its financial stability responsibilities discussed earlier.

Expanded use of regional and bilateral arrangements

3.24. Regional and bilateral arrangements can play a significant role in supporting countries facing capital account shocks. This support can take different forms. For example:

- The EU has long-established facilities to provide financial support in its region through lending and co-financing IMF programmes. In the current crisis the EU has committed €15billion.
- Through the Chiang Mai Initiative (CMI), the ASEAN +3 (China, Japan and South Korea) countries have established a network of currency swaps (currently \$80billion) which gives an individual member access to some part of a partner country's reserves in the event of a crisis, thereby reducing the need to build their own reserves as much as they otherwise would. While the CMI has not yet been deployed, the members have agreed to increase its size to \$120billion.
- During last year's crisis the US Federal Reserve opened swap arrangements with Brazil, Mexico, Korea and Singapore with each line able to provide up to \$30billion of finance. These arrangements played a significant part in bringing stability to these countries' financial positions.

3.25. Some countries may be more willing to use regional or bilateral arrangements than IMF borrowing because they are more acceptable politically, although they may not all reduce demand for precautionary reserves in the same way. Equally, regional agreements cannot substitute for the IMF. But they can potentially play an important role both to supplement and complement the IMF's global role as a provider of support.

3.23. As well as ensuring countries have access to a sufficient quantity of finance in the event of a crisis, it is also important that there should be sufficient flexibility in the way it can be used. The current crisis has shown how sudden stops in international capital flows can impact economies through the private and banking sectors and it is important that IMF support can address problems in the most direct and effective manner. Given the close relation between fiscal and current account deficits present arrangements give some flexibility in practice. Nonetheless, the parameters of what the IMF can/cannot do should be clearly established. For example, in exceptional circumstances, it might be appropriate for the IMF to support a member government's short-term financial assistance to its national banking system. This would also be

3.26. Such arrangements are now part of the international financial architecture. To ensure the smooth interaction in a crisis of these arrangements and IMF funding it will be important to assess:

- The possible advantages of direct regional input to the design of Fund programmes.
- How consistency in lending policies, including pricing, between different institutions can be assured.
- The scope for the IMF to provide technical assistance to the development of regional arrangements through support on surveillance, the development of standardized swap contracts and the provision of treasury assistance.
- The scope for development of additional regional pooling agreements in areas where countries have available reserves and which are sufficiently cohesive politically.
- The scope for a 'back stop' facility provided by the IMF to support well-established regional arrangements.
- The benefits of a clear global framework for ensuring coherent and complementary IMF and regional financing.

The G20 should establish an expert working group on capital account crises to:

- **examine the modalities for the Fund to provide to provide fiscal - as well as balance of payments – financing and develop options for Finance Ministers to consider;**
- **assess the lessons learned from the use of bilateral swap lines in the crisis;**
- **develop a framework of principles which would set out how bilateral, regional and global financial arrangements (including those provided by the IMF) can work more effectively together in the future.**

The group should report to the G20 by April 2010.

The Multilateral Development Banks (MDBs)

- 3.27. In addition to the short-term balance of payments needs which IMF finance is designed to meet, the crisis has also revealed a greater need for fast disbursing MDB finance to meet the needs of developing countries, especially Middle Income Countries, with large privately financed infrastructure programmes and high exposure to volatility in capital market flows.
- 3.28. The withdrawal of private sector finance from such projects, as liquidity in markets has fallen and the perception of risk in developing countries has increased, risks decreasing long-term growth. The official sector typically supplies project finance and direct budget support to countries through the Multilateral Development Banks. The latter have responded well to the crisis by raising their lending and making more efficient use of their capital bases. But more needs to be done to meet the shortfalls in private flows that have now become apparent and to support demand in the world economy particularly over the next few years as we adjust to a new pattern of global growth. There are three ways this should be achieved.
- 3.29. First, by making more efficient use of existing MDB capital. For, example, guarantees provided by the World Bank and IFC – whether partial risk, partial credit, policy-based or enclave – are proven counter-cyclical instruments that can overcome these concerns. These guarantees reduce investor risk and attract longer-term private finance in large multiples, typically 6-13 times the guarantee's face value. Moreover, guarantees provided in local currency help to develop domestic and regional capital markets, on which future long-term financing will depend. This would in turn strengthen countries resilience in the face of future withdrawals of external finance.
- 3.30. There are a number of technical and procedural steps that can be taken to facilitate the greater use of guarantees that in the World Bank could be

doubled to support an additional \$10 billion to \$15 billion of private project finance. These include the rules which require guarantees to have as much capital backing as loans and the need to strengthen incentives to use guarantees.

The G20 should call on the World Bank and other MDBs to make greater use of guarantees as an efficient use of capital. This includes supporting the current review by the World Bank of its present scoring ratios on guarantees; doubling of the overall volume of WB guarantees; simplifying administration and due diligence; undertaking marketing and training for staff and clients; and providing technical support for guarantee projects in frontier markets.

- 3.31. Second, by building on the experience of the recent crisis to develop a more systematic approach to temporarily and swiftly increasing the amount of capital available for example by increasing callable capital and temporarily raising maximum leverage ratios during times of crisis. The World Bank and MDBs need an emergency arrangement which enables them to draw temporarily on shareholders in a crisis.
- 3.32. At the same time, the World Bank and MDB balance sheets are a very strong global asset. A willingness by shareholders to use the Bank's balance sheet more aggressively in exceptional circumstances would significantly expand the financing available to sustain recovery from crises and support global demand. For example, World Bank figures show that allowing its equity to loan ratio to fall to a minimum of around 20 per cent in FY2019 - the lowest level it still considers technically prudent - would allow the Bank to double the \$61 billion crisis lending it has already committed to provide, while still keeping the Bank within its statutory limits.

The G20 should call on the World Bank to put in place a pre-agreed framework for temporarily raising leverage ratios and accessing additional callable capital in the event of global crises and sudden stops.

The G20 should ensure the World Bank, and other MDBs, are adequately capitalised to meet future needs, including reviewing whether further General Capital increases are needed. These reviews must be accompanied by rapid progress on governance, accountability and operational effectiveness and be completed by Spring 2010.

- 3.33. Third, by assessing whether the World Bank and other MDBs, as a group, need a permanent capital increase, given the likely long-term demands on their balance sheets. This should distinguish between the likely longer-term demand for MDB lending and demand related to the current crisis which could persist into the medium term as far as access to finance is concerned. It is important that governments are able to take a view across the system as to where more capital is needed and whether the need is permanent or temporary. Action should be taken quickly given the shortage of demand in the global economy.
- 3.34. Alongside consideration of resources, reforms should also be made to increase the World Bank's legitimacy, relevance and effectiveness, including: to the distribution of voting power and decision-making between its members; to how the Bank's strategy is formulated; to how the Bank's President and senior management are selected and held accountable for their performance; and to the division of labour between the Governors, Board and Management. Improvements in the Bank's governance structures coupled with better operational effectiveness and stronger partnership working would give shareholders greater confidence that resources provided to and through the Bank will reduce poverty and foster sustainable growth.

CHAPTER 4: MEETING THE DEVELOPMENT CHALLENGE IN TIMES OF GLOBAL CRISIS

4.1. The global economic crisis has affected every country in the world. The poorest individuals and countries have been most adversely affected, despite being the least responsible for causing the global shock. The consequence has been seen in the increasing levels of income poverty globally and the reversal of progress towards the other Millennium Development Goals (MDGs).

4.2. The crisis has shown that, in the face of global shocks, the international mechanisms to sustain progress towards the MDGs are lacking. The system for providing concessional finance lacks flexibility and size, relative to the scale of the task. Although steps have been taken by the G20 and the IFIs to support development objectives in the face of the crisis, the international system as a whole should do more.

4.3. Previous chapters have centred on the necessity of supporting sustainable and stable global growth. The proposals made are also important for the achievement of the MDGs and should support the fair and equitable global growth.

4.4. This chapter sets out the cost of the impact of the crisis on the poorest and also makes proposals for action by the International Financial Institutions to assist countries minimise the impact of the crisis on their short and achieve long-term development objectives.

Background

4.5. In the past generation, significant progress has been

made in tackling global poverty. 500 million fewer people live in poverty than twenty-five years ago. Despite the rapid growth in the global population, real incomes in the developing countries have doubled, child mortality has almost halved and the number of children out of school has dropped by 28 million. This overall stronger performance was supported by:

- improved policy making;
- buoyant global markets;
- higher commodity prices that strengthened fiscal and external accounts; and,
- greater support through aid and debt relief under both the HIPC and Multilateral Debt Relief Initiatives.

4.6. Low income Countries also became more fully integrated into the global financial system. Accessing foreign savings through the international capital markets has been an important part of many countries growth strategies. But this new level of integration also increased vulnerabilities. Although only a small proportion of global private capital flows to LICs they absorb a disproportionate amount of the volatility in the global economy. An absence of reliable market information and high transaction costs exaggerates investment risk in developing countries, prompting a 'flight to safety' in the event of a crisis, discouraging inflows, and undervaluing the benefits of investment in LICs.

- 4.7. These countries also have less policy flexibility to manage this volatility. The financial crisis has come at a time when both reserve levels and fiscal space in these countries had already been eroded by the impact of higher food and fuel prices. This left countries exposed as trade values and volumes reduced. Foreign Direct Investment fell, remittance inflows declined and domestic tax revenues have contracted as economic activity has slowed.
- 4.8. In financial terms the effect has been a significant financing gap for LICs. In March 2009, IMF estimated that the financing need for 2009 in IDA-only LICs could be as high as \$97 billion. Even after taking account of additional IMF support and the global allocation of \$250 billion of Special Drawing Rights (SDRs) through the IMF, these unmet financing needs could be as high as \$31 billion. The crisis is estimated to have put back progress to the MDG of halving the number of people living on less than a dollar a day by 3 years. Materially this means that 90 million more people will be left in extreme poverty each year after 2010 with incomes in developing countries permanently 7 per cent lower as a result of the crisis.

Short-term support

- 4.9. In the short term, the G20 has recognised the responsibility to protect the poorest against the social, political and humanitarian costs of the crisis. At the London Summit, G20 Leaders agreed to provide \$50 billion in additional resources through the IFIs to support social protection, boost trade and safeguard development in low income countries. These resources are on track to be delivered. They also reaffirmed their commitment to meet the Millennium Development Goals and achieve their ODA pledges.
- 4.10. But short-term responses need to be supplemented by systematic changes to ensure that the IFI architecture is better designed to mitigate the impact of future crises on the poorest and to safeguard global potential. There is still potential for growth in these countries to play a role in the healthy rebalancing of global growth at a time when growth is likely to remain sluggish in large parts of the global economy. Finance provided promptly in a crisis can protect development gains and returns to fast-disbursing, counter-cyclical finance in LICs are high.
- 4.11. Three key failures, identified in the response to the current crisis, must be addressed to ensure the international system is primed to mitigate the effects of any future crisis:
- a lack of sufficient available resources;
 - a lack of scaling of resources to need; and,
 - inadequate speed of response.

Multilateral Development Banks – Concessional Finance

- 4.12. The World Bank and other Multilateral Development Banks (MDBs) are a primary source of finance and expertise for developing countries facing macroeconomic shocks. The MDBs have responded to LIC needs by frontloading concessional resources and redirecting finance to priority projects. However, they only have limited flexibility to respond to a shock. For developing countries to protect development gains, and pre-crisis spending and investment plans, funds must be provided more quickly and flexibly in the event of a crisis.
- 4.13. The level of concessional financing, including IDA resources allocated to LICs, is still determined by replenishment agreements and allocated on the basis of inflexible backward-looking assessments. Re-profiling programmes at country level can have only limited impact. Any additional capacity is often dependent on the extent to which surplus funds are identified at the country level or ad hoc resources provided by donors. As a result, LICs cannot rely on timely and flexible support from the MDBs in the event of a crisis when temporary additional aid would be most effective. Current facilities are not designed to fill these needs.

- 4.14. This points to the need to create a crisis response mechanism in IDA that would enable finance to be brought forward to fill gaps in the event of a crisis. It would need to be: additional to current allocations; fast-disbursing; counter-cyclical; and pre-agreed in size and terms of access. This would assure LICs of prompt assistance during severe and widespread shocks. There is a distinct role for IDA resources to support budgetary expenditure.
- 4.15. The purpose of the proposed facility would be to finance crisis-affected development expenditures, including social safety nets. The facility would need to operate under significantly faster than normal project development, approval and disbursement procedures – with due diligence focused on crisis impact. The facility would be activated – become ‘open for business’ – by pre-agreed triggers to be developed by the World Bank. Such a facility should be located in IDA and lent on IDA terms - access to and eligibility for support from the facility for individual IDA countries would be based on pre-agreed criteria. These criteria could include fiscal, poverty, and growth impacts in LICs. The assistance could then be allocated according to project and programme priorities (fiscal and poverty-related) identified by the World Bank and the LIC. The facility as a whole would be automatically deactivated after a pre-set period of time, or when agreed ‘closure’ trigger points are reached. However it would remain part of the IDA architecture, to be triggered only in times of the crisis.
- 4.16. There is no easy way of defining the appropriate size of the facility. The broad size of the facility should, in principle, be determined by the likely scale of future shocks, reflecting an appropriate level of additional effort through IDA. However, the World Bank estimates the fiscal financing gap to be \$11.6 billion in 2009. This represents the additional finance need to protect core spending in the face of revenue losses caused by the crisis. As an indication, financing at this level would have provided an average of around 40 per cent of the overall external unmet financing needs in each IDA-only country in the current crisis, excluding Sudan and Angola.
- 4.17. The approach to financing for the facility requires flexibility. It is inefficient for donors to endow a facility in advance – locking up scarce grant resources for shocks which may or may not happen. The approach to financing will also depend on the type and severity of shock. A shock like the current crisis that also hits donor countries severely could require a different approach to financing than one that is limited to developing countries. One potential solution is to obtain a commitment now to the facility’s broad funding principles, its structure and its scale, its triggers and access criteria. This would provide sufficient certainty to ensure that the facility will deliver in crises, but without locking up resources in advance.
- 4.18. The facility could use a mix of World Bank (IBRD) and donor financing. In crises when the possibility of up-front donor financing is constrained, the World Bank could agree to provide the underlying capital for the facility – delivering immediate and additional finance for LICs using its strength and leverage capacity. Donors would, in parallel, make commitments to subsidise the cost of World Bank capital for LIC borrowers and as necessary ensure that World Bank is paid back.
- 4.19. In the event of an extreme and widespread global crises when additional donor capacity is constrained, the option of sharing these future costs with IDA should also be considered – recognising the strong case for bringing money forward to deal with shocks.

The G20 should agree to support the creation of a new crisis response facility in IDA to fund critical development expenditures, including social safety nets, in times of crisis without tying up scarce development resources in advance of need.

The IMF and LICs

- 4.20. While the World Bank and MDBs play the central role in providing support and grants for LICs, the IMF has also played a significant role in supporting the strengthening of macroeconomic policymaking in the LICs over the last ten years. Reforms of facilities and culture in the Fund over that period have slowly brought a greater focus on the need for long-term engagement by the international community to support countries own economic policy objectives. This has been supported through access under the Poverty Reduction and Growth Facility (PRGF) that has provided finance to countries in response to the long-term balance of payments that they face.
- 4.21. The IMF has shown itself able to respond rapidly to the impact of crisis. The Fund has reacted by increasing the volume of financial resources available on an unprecedented scale - going above and beyond the London Summit commitment. To accommodate the increase in demand, the Fund is raising capacity to allow concessional lending to be increased by up to \$17 billion between now and 2014, front-loading assistance through the Poverty Reduction and Growth Facility so that \$8 billion becomes available in the first two years, when needs are greatest. In 2009-10 support will be more than triple what was available before the crisis. The IMF has also doubled access limits (the amount which individual countries are able to borrow) and increased the concessionality of lending by waiving interest payments through to the end of 2011.
- 4.22. In recent months, the IMF has overhauled its entire set of facilities for LICs to reflect the diverse circumstances of LICs. The aim is to produce a more complete coverage for countries in the face of the pressures they face including economic crisis. These mirror the reforms made to the facilities for other members of the Funds with a facility to deal with medium term needs to replace the PRGF; a more flexible facility to provide short term support to countries and a rapid access facility with limited conditionality for use especially in post-conflict situations. These reforms should represent a significant step forward by the Fund and it will be important to keep their effectiveness under review.
- 4.23. In consultation with low-income countries there has been praise for many of the improvements made by the IMF, particularly in terms of the greater flexibility in the assessment of the implementation of structural requirements on countries and programme design. However, despite the progress made in putting in place significant short-term resources in response to the crisis, there is a question as to whether this level of support can be sustained in the medium to long-term. It is clear that the PRGF is not adequately resourced to meet the development challenges going forward.
- The Fund should conduct a systematic analysis of its lending to LICs to assess whether the scale of resources meet potential demands from LICs overall and are appropriately scaled to the needs of individual countries.**
- 4.24. The \$250 billion allocation of SDRs by the IMF is currently distributed according to quota share. The result is that the majority of the increase implemented at the end of August has gone to developed countries, which arguably are in least need of the increased protection the SDR offers. Only \$18 billion of the SDR allocation has gone to LICs to shore up reserves and relax financing constraints. There is therefore scope to consider the further role that SDRs can play in supporting LICs in facing balance of payments pressures.
- 4.25. The London Summit focused on providing the necessary subsidy resources, through the use of the Fund's surplus income and profits from gold sales, to increase lending to LICs. The Fund is in the process of implementing this but still needs capital resources. As the Fund has proposed, countries could lend a proportion of their SDRs to the Poverty Reduction and Growth Trust (PRGT) to provide the capital for IMF loans to LICs.

The G20 should encourage countries to lend a proportion of their SDRs to ensure that the Fund has the capital resources it needs to support lending to LICs.

Long-term support

- 4.26. To increase the robustness of LIC and other developing economies to shocks in the long-term the G20 should also stimulate new sources of investment in normal times. One approach would be to facilitate enhanced deployment of existing national foreign exchange reserves.
- 4.27. Proposals in Chapter 3, to improve the effectiveness of the IFIs in providing finance to offset the effects of exogenous economic shocks, will help reduce the need for further reserves accumulation but large existing stocks of reserves will be a reality for the foreseeable future. Many countries have established Sovereign Wealth Funds to hold and invest reserve holdings, but these resources are not used as efficiently as they could be.
- 4.28. There is scope to increase the returns to these reserve holdings and raise growth in developing countries by overcoming the barriers to investment of these resources in infrastructure projects in developing countries, including the poorest. A 'Fund of Funds' financed by the private sector and managed by a private Fund Manager could be developed to assist this process. Working with the IFC and other private sector-focused IFIs, it would link institutional investors and private firms active in developed world markets, with bankable infrastructure projects in developing countries. The Fund of Funds could attract up to \$50 billion of private financing, anchored in seed-financing from SWFs and other investors.
- 4.29. Such a Fund would need to follow internationally recognised governance principles for mutual funds in terms of shareholding and voting rights, and segregation of fully commercial from subsidised

interventions. Within a global fund, it might be possible to specialise in particular sectors. There is already significant demand from investors for a Fund of Funds focused on climate change and renewable energy finance. Similarly, there may be scope for smaller, regional sub-funds within the Fund of Funds run by Fund Managers who offer specialist regional expertise.

- 4.30. The World Bank's role in supporting the Fund of Funds would be to help countries develop viable projects to create a global project pipeline. It could also offer a package of risk mitigation instruments for Fund of Fund investors. Through the Fund of Funds and the support of the World Bank, investors could expect higher returns than by buying government debt. The pooling of resources would also allow investors to spread risk, increase liquidity relative to direct investments and possibly reduce the restrictions over foreign ownership of strategic assets that can arise with individual SWFs. The chief benefit to recipient countries is access to substantial, long-term finance and – mirroring the benefits for investors – avoiding any possibility of political pressure from a single SWF.

The G20 should call on the World Bank to develop with institutional investors a privately financed and managed 'Fund of Funds' for SWFs and others, facilitating investment in infrastructure in developing countries.

- 4.31. The LICs and other developing countries are among the most threatened by climate change. They are also the most vulnerable given that they are the least able to adapt. This will be one of the most important issues to be addressed by the Copenhagen Summit later this year. The box below sets out a possible approach in more detail.

Box 4- Addressing the challenge of climate change

Climate change poses one of the greatest risks to our economies, societies and ecosystems. Those most vulnerable to the effects of climate change are also those least able to adapt, putting achievement of the Millennium Development Goals at risk. Sustainable global growth and rising living standards will only be possible with effective, global action to tackle the threat of climate change and limit global temperature increases to no more than 2°C.

Enhanced financial cooperation between developed and developing countries is needed to address the challenge of climate change, according to the principle of common but differentiated responsibilities and respective capabilities. Developing countries must design and implement ambitious low carbon development plans for mitigation and climate resilient development plans for adaptation, while developed countries have a responsibility to support this action, through the provision of finance. In this context there is a clear need for:

- a substantial increase in public and private finance to help developing countries implement strategies for mitigation and adaptation. Around \$100 billion of public and private finance each year by 2020 will be needed;
- new sources of public finance that are additional to existing aid commitments and accounted for in a fully transparent manner, so maintaining our commitment to meet the Millennium Development Goals;
- financial flows that are predictable and provide the degree of certainty that developing countries need to be able to

plan ahead and implement effectively their climate strategies;

- increased private sector finance, through an expanded and enhanced global carbon market, the linking of trading schemes, the establishment of new sectoral mechanisms and reforms to the offset market; and
- a fair system of financial contribution, based on a universal contribution key which reflects each country's ability to pay and their emissions, and with all countries except the least developed contributing.

To underpin these new sources of finance, stronger and more effective institutional arrangements will be needed. In recent years, the World Bank and the MDBs have taken increased action to mainstream climate considerations into their operations and to help countries finance key adaptation and mitigation activities, working with and alongside other organisations including the UN. But the system overall has grown in a piecemeal fashion and is too complex and ill-equipped to provide the coordinated long-term support to integrated country programmes that will be needed to address the scale of the challenge ahead.

The new financial architecture for climate change must be representative of developing as well as developed countries; ensure that international standards of financial management are met so that it is clear what results will be delivered from the funding provided; deliver coherence between different financial instruments to simplify arrangements for developing countries and obtain maximum value from climate funding; and guarantee the provision of finance quickly and at scale in support of country-led climate strategies, with

a far greater focus on support for programmes to support the transformation of economies and societies as a whole. To deliver this:

- the World Bank and the other MDBs must continue to play an important role: supporting developing countries in the preparation of integrated climate and development strategies; providing strong financial control over climate funding; and managing the delivery of key finance streams; and,
- a new high level body that is fair, efficient and representative, should be established to assess and provide guidance on needs and sources of funding, and to ensure that finance is allocated according to the most pressing instruments and needs.

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