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FOSTERING AN ENABLING ENVIRONMENT FOR DEVELOPMENT: FINANCIAL FLOWS, INCLUDING CAPITAL FLOWS; INVESTMENT; TRADE

Report of the Secretary-General

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INTRODUCTION

1. At its resumed substantive session of 1996, the Economic and Social Council decided that the theme of its 1997 high-level segment would be "Fostering an enabling environment for development: financial flows, including capital flows; investment; trade" (decision 1996/310) and requested the Secretary-General to submit a report prepared in collaboration with the Bretton Woods institutions and the World Trade Organization (WTO).[1] The present report, which is submitted to the Council in response to that request, was prepared by the United Nations Secretariat (Department for Economic and Social Information and Policy Analysis and Department for Policy Coordination and Sustainable Development), in collaboration with the United Nations Conference on Trade and Development (UNCTAD) and the World Bank. Inputs to the report were also provided by the International Monetary Fund (IMF) and WTO, as well as by the United Nations Children's Fund (UNICEF), the United Nations Development Programme (UNDP), the Food and Agriculture Organization of the United Nations (FAO), the International Labour Organization (ILO), the United Nations Industrial Development Organization (UNIDO) and the United Nations Educational, Scientific and Cultural Organization (UNESCO).

What is an enabling environment?

2. An enabling environment, understood in its broadest sense, encompasses the whole panoply of national and international policies, measures and institutions in the economic, social, legal and political domains that influence or affect the growth and development prospects of a country. Fostering an enabling environment for development implies a concerted effort by Governments at the national and international levels, in collaboration with other actors in development, to ensure that the interplay among those policies, measures and institutions and the sum total of their impact promotes not only sustained economic growth but a development style that is sustainable and broad-based and whose benefits are shared equitably by all members of society.

3. The World Summit for Social Development specified the key components of an enabling environment for social development. Similarly, other United Nations conferences have touched on various facets of an enabling environment. The present report does not attempt to synthesize all these agreed frameworks. It focuses on the issues identified in the selected theme and has been guided by the objectives for the high-level segment of the Economic and Social Council set out in General Assembly resolutions 45/264 and 48/162.

4. The key characteristics of an enabling environment are well understood and generally accepted: stability, predictability, adaptability, growth orientation, transparent legal and regulatory frameworks, and a strong base of social and physical infrastructures. It implies that countries follow sound and growth-oriented policies.

5. However, the effort at the national level to improve the environment for development cannot proceed in isolation from, nor is it immune to, the international policies and institutions and the global trends that frame, favourably or otherwise, the national environment for growth and development.

This is particularly relevant today when the gathering pace of globalization is eroding the ability of Governments to influence economic outcomes and, at the same time, turning the external environment into such a crucial factor that no Government is able to cope with all of its repercussions alone.

6. Developing countries, with their limited capacity to adjust to and absorb external shocks, are particularly vulnerable to rapid changes in the international economic environment. This environment, in turn, is determined primarily by the monetary, fiscal, trade and other policies of major industrialized countries, by market and technological forces and trends and, for developing countries at least, by the policies pursued by multilateral financial institutions and WTO, as well as by the state of development cooperation in general.

Globalization and world economic prospects

7. Globalization and the issues arising from it are particularly relevant to the international debate on fostering an enabling environment for development. The process of globalization is transforming the world economy and changing the nature of international economic relations. As part of this process, the developing world has also changed dramatically. New and dynamic centres of growth, trade and investment have emerged in Asia and parts of Latin America. In other parts of the developing world, growth prospects are also improving, although for Africa and the least developed countries, the risk of further marginalization remains real. The prospects of these countries are clouded by shrinking official development assistance (ODA), low levels of foreign direct investment, the burden of external debt and worsening terms of trade.

8. A majority of developing countries now accepts and pursues the macroeconomic and outward-oriented policies required to foster rapid economic growth. Structural adjustment and economic reforms are being pursued, more or less consistently, in a large number of countries. Entrepreneurship and the private sector are widely recognized as dynamic factors of growth. Similar policies are also being applied in the transition economies. As a result, for the past few years, developing countries as a whole have been growing more rapidly than the developed ones and their share in world trade and capital flows has been rising. The transition economies are also moving along a path of steady and accelerating expansion.

9. One consequence of these positive trends is that the developed and developing worlds are becoming more and more mutually interdependent. Many of the most dynamic markets and investment opportunities today are in some of the developing countries and in countries with economies in transition. Indeed, viewed in a longer term perspective, it appears that the world today is at the threshold of sustained global economic expansion. However, the institutional and policy framework required to fully exploit this global opportunity is not yet fully in place.

10. As the global environment becomes more fluid and the pace of change accelerates, the case for developing new forms of international cooperation to cope with and manage the associated risks and challenges is evident; but in the present global economy, such cooperation cannot be confined to Governments

alone; it must also include a wide range of actors. Conditions are propitious for putting in place the foundations for such international cooperation. The United Nations conference processes showed how this larger collective endeavour can take effect. In the post-cold-war period, economic and social issues can be discussed in a pragmatic way. Furthermore, policy makers in all countries are confronted with the need to deal with the implications of globalization in the light of conditions specific to each country. The policy dilemmas they face are in some respects similar, although their depth and severity differ greatly from country to country.

I. FRAMEWORK OF INTERNATIONAL COOPERATION AND NATIONAL POLICIES

11. Each country has the primary responsibility for its own development. However, international cooperation and partnership have a vital role in creating a favourable climate for capital flows, investment and trade to flourish. Many developing countries, particularly those in Africa and the least developed countries, will continue, for the foreseeable future, to require assistance to carry out these policies and reforms successfully, and developed countries have a major responsibility to create and sustain an enabling environment for their development.

12. The broad elements of an enabling international environment for development are essentially the same as those that are relevant at the national level: creation and maintenance of peaceful and stable international conditions; democratization in international relations, establishment of open, fair, equitable and transparent international regimes; respect for and non-discriminatory application of the rules of the game so as to create equal opportunities and a level playing field for all; and protection of the weakest and the most vulnerable members of the international community through more favourable treatment in trade and finance.

13. The above calls for coordination in the formulation and implementation of macroeconomic policies by major industrialized countries to create and sustain conditions of stability, predictability and growth in the world economy, stable exchange rates, low interest rates and fiscal deficits, as well as trade liberalization, more equitable access of developing countries to global markets, an increased flow of productive investments and technologies and appropriate knowledge to developing countries, as well as new and additional financial resources.

14. A general consensus on the policies required to foster an enabling environment for development at the national level has emerged. Recent experience has shown clearly that these policies are also the ones most conducive to investment (domestic and foreign), capital inflows and successful integration into the world economy through trade.

15. First and foremost, reinforcing peaceful conditions, a stable political framework, full respect for all human rights and fundamental freedoms, and effective participation by civil society are indispensable foundations for sustainable development. Further, a stable and transparent legal framework that provides for respect for and enforcement of property rights, the rule of law and

the tackling of corruption, as well as transparent, efficient and accountable public administration, are conducive to domestic and foreign investment and capital inflows.

16. Equally, an essential component of an enabling environment for development is sound national macroeconomic policies. Investment (domestic and foreign), capital inflows and access to foreign exchange are facilitated by a low and predictable rate of inflation, a sustainable fiscal deficit and a realistic exchange rate. In a world of integrated financial markets and rapid capital movements, it is also essential to ensure the soundness of the banking system through prudential regulations, better assessment of credit risks, stringent capital requirements, actions to prevent money laundering, improved management of banks and better regulation of security markets. Economic and social development also require the promotion of dynamic, open and free markets because they are an efficient means of resource allocation and an instrument for harmonizing divergent interests. Countries should undertake any necessary structural adjustment and reform, and pursue their outward-oriented policies. Internationally agreed rules such as those relating to an open and free multilateral trading system tend to strengthen the basis for sound national policies.

17. Macroeconomic policies should also be perceived as sustainable. Consequently, the social costs of such policies, and their impact in terms of recession and unemployment, cannot be ignored. Hence, in certain circumstances Governments will need to intervene in markets to prevent or counteract market failure, promote stability and long-term investment, ensure fair competition and protect social equity by ensuring the provision of social services.

18. Non-governmental actors and, in particular, the private sector are playing an increasingly important and dynamic role in promoting development, with the result that Governments are re-examining and adjusting the extent and scope of public sector involvement in the economic sphere. However, Governments have a definite economic role: they must ensure an appropriate policy environment, encourage entrepreneurship, create favourable conditions for the business sector and for attracting foreign direct investment, provide basic infrastructures and develop human resources.

19. Growth and development are stimulated by the greater integration of developing countries into the world economy. However, the problems of marginalization, volatility and vulnerability are not solved by world markets alone. Hence, the following questions arise: How can greater consistency between aid, trade and investment policies be ensured? What should the international response to the problem of marginalization be? How can the increased international and domestic fragility in the global environment be reduced? What should the role of ODA be? How can greater market access and more widespread capital and investment flows be promoted?

20. It is important that Governments engage in a dialogue on these critical issues in order to devise practical policy responses that would ensure the long-term stability and viability of the global economy by promoting fairness and equity and participation by all countries and groups within countries in the benefits of growth and development. The following sections address these

questions and identify possible approaches that could help in the search for viable and long-term answers.

Recommendations:

*1. The Council may wish to emphasize the need for strengthened international cooperation to enhance the benefits and mitigate the risks associated with globalization and to better integrate developing countries in the world economy. This would imply, among other things, more systematic attention to policy coordination to achieve greater coherence among macroeconomic, trade, financial and development aspects of economic policy-making by countries and at the global level.**

2. The Council may stress the importance of sound and stable macroeconomic policies for accelerated growth through better integration in the world economy. Equally important is the need for the rule of law, a stable and transparent legal framework and public administration, and policies that promote entrepreneurship, savings and investment. The establishment of realistic exchange and interest rates, reform of the trade and payments system, as well as the liberalization of other domestic prices should continue as they provide an appropriate incentive structure for producers and encourage outward-oriented growth strategies.

3. The Council may urge that structural reforms aimed at establishing a competitive domestic financial system, privatization and/or restructuring of public enterprises continue to be implemented in order to enhance the efficient allocation of resources and support private sector development; such reforms are also expected to boost domestic savings and investment and thereby contribute to higher economic growth.

4. The Council may emphasize that the availability and proper maintenance of adequate economic infrastructure, in particular a trained workforce and telecommunications and transportation facilities, affect the pace of integration of countries in the world economy and should be of high priority. High-quality communications are essential for countries that aim to participate in the globalized production structures established by multinational corporations, to respond promptly to rapidly changing market conditions in industrialized countries or to participate in new export markets. The Council may wish to call for innovative policies designed to promote public-private partnerships and opening up the social and infrastructure sectors to private investment to meet the enormous needs in these areas.

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* Recommendations contained under the remaining sections of the report address more specific aspects of international cooperation for fostering an enabling environment for development.

II. POLICY ISSUES

Policy coherence

21. With the accelerating integration of the world economy, the interaction between the macroeconomic, structural, trade, financial and development aspects of economic policy-making has increased and is likely to intensify further. Moreover, the opportunities and risks associated with globalization are unevenly distributed because of imperfections in factor and product markets. A more equitable distribution of benefits and mitigation of risks require careful management of public policies and coordination of national and global policies dealing with markets, as well as stronger international support for infrastructure and human resources development in developing countries. In the current economic environment, the question of policy coherence has thus emerged as a critical one for all participants in the global economy.

22. Policy coordination at the global level has been pursued sporadically in the context of the group of seven major industrialized countries (Group of Seven). The Interim Committee of IMF regularly considers the coordination of national economic and financial policies. At its meeting in September 1996, for example, the Committee adopted an 11-point Declaration on Partnership for Sustainable Global Growth.[2] In April 1997, the Committee reaffirmed that implementation by all members of the guidelines set out in the Declaration would be essential to ensuring that all shared in an increasingly prosperous world economy. WTO was requested, at its Ministerial Conference held at Singapore in December 1996, to study the interrelationships of trade and investment further, and trade and competition policies and working groups have been set up for this purpose. Yet the consistency among the trade, aid, financial and environmental aspects of policies remains an important concern that is not addressed comprehensively or coherently in any global forum. Similarly, at the national level, in many countries the institutional arrangements for addressing issues of coherence among policies are either weak or have not been put in place.

23. The task of achieving greater harmony between these policies lies primarily with Governments at the national level. However, as recognized in the Ministerial Declaration on this issue, adopted at Marrakesh, Morocco, at the conclusion of the Uruguay Round of multilateral trade negotiations, their coherence internationally is an important and valuable element in increasing the effectiveness of these policies at the national level.[3]

24. The strengthened multilateral trading system emerging from the Uruguay Round is expected to contribute to more effective surveillance and to strict observance of multilaterally agreed rules and disciplines so that trade policy can play a more substantial role in ensuring the coherence of global economic policy-making. The Marrakesh Declaration stressed the importance of efforts to improve other elements of global economic policy and called upon the international institutions with responsibilities in the areas of trade, money and finance (WTO, IMF and the World Bank) to follow consistent and mutually supportive policies.[3] In this context, it is necessary to avoid the imposition of cross-conditionality or additional conditions. WTO and the Bretton Woods institutions have recently concluded an agreement to exchange views regularly through participation in each other's meetings. The staff of these institutions

are also developing pragmatic working relationships. It is too early to say, however, to what extent coherence in policy-making has actually been enhanced.

25. An important aspect of policy coherence that affects the international environment for developing countries is the need for greater coherence among development cooperation policies. The development objectives that these policies are designed to promote, particularly in the poorest countries, will have a greater chance of being attained if Governments consider the overall developmental impact of their trade, aid and investment policies. By the same token, developing countries must also ensure greater consistency among their policies designed to promote trade and investment.

26. As national institutions are not always organized to take a comprehensive and coherent view of these policies, certain inconsistencies among them can arise. For example, concessions in the areas of trade and finance can be offset by changes in exchange rates or interest rates or by domestic subsidy policies. Interest rate increases in major industrialized countries can trigger capital outflows or raise debt burdens in developing countries. A deflationary bias in the macroeconomic policies of major industrialized countries could have negative repercussions on commodity prices that could more than offset aid flows to commodity-exporting countries, which are mostly in Africa or are least developed countries. Agricultural subsidies distort agricultural trade and perpetuate inefficient production patterns by eroding comparative advantage.

27. There are no easy solutions to such policy conflicts, but it may be useful to examine the extent to which such issues could be discussed and resolved within a global framework. The recent initiative of the Organisation for Economic Cooperation and Development (OECD) to monitor the implementation of the OECD/DAC development consensus[4] in some African countries suggests that Governments are beginning to respond to the need for such a coherent approach. But the OECD initiative is a limited one and does not involve the participation of developing countries.

28. The World Trade Organization provides an example of how a framework may be designed to deal with the question of policy inconsistencies in money, finance and development cooperation. The WTO working groups on coherence, on trade and investment and on competition are studying various aspects of the interlinkages between trade, investment and competition policies. The question is, how can greater coherence in economic policy-making at the global level be pursued with wider participation and to the benefit of all? More specifically, can development cooperation policies be appraised, in a multilateral context, in terms of their overall impact?

29. In this context, one also notices that policies aimed at building a more open international trading system are often questioned in industrialized countries on the grounds of their adverse effects on employment and wages. The high unemployment rates prevalent in Western Europe and stagnant wage levels in OECD countries in general are used by some as a rationale to advocate protectionist approaches. In a low-growth, high unemployment environment, low-cost imports from developing countries are presented as a threat to economic well-being. Although, in the Declaration adopted by the WTO Ministerial Conference in Singapore, Ministers rejected the use of labour standards for

protectionist purposes and agreed that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question, the continuing calls for higher labour, social and environmental standards are seen by many in developing countries as a way of promoting new and disguised forms of protectionism. These conflicting perceptions and the underlying policy dilemmas could be reconciled better in the context of a more comprehensive and global policy dialogue designed to promote coherent policies in all countries for more balanced growth and development and to reduce unemployment in developed and developing countries.

30. Another aspect that needs urgent attention is the whole question of subsidies as these directly affect coherence among fiscal, trade, investment, competition and aid policies. The growth of subsidies tends to increase inconsistencies among these policies. Subsidies are pervasive in developed and developing countries, though applied for different purposes and in different sectors. While any generalized statement on as complex an issue as subsidies can be misleading, there is clear evidence that subsidies often have a distorting effect. The most commonly subsidized sectors are energy, infrastructure and agriculture as well as food and other basic needs and social services. Often designed to meet a perceived social need or economic goal, subsidies tend to distort resource allocation through inefficient price and incentive structures and reduced competition. It has been shown through specific case studies that subsidies often do not serve their intended purpose, create dependency and addiction, entail a large fiscal drain and often end up benefiting the better-off rather than the poorest groups in society.[5]

31. Reshaping subsidies based on detailed evaluation of their impact would in most cases yield economic, fiscal and efficiency gains through greater policy coherence and may lead to greater equity as well. However, Governments may be reluctant to act unilaterally because of political constraints or a perception that such action in isolation may reduce competitiveness.

32. More transparency through more direct policy measures is the key to subsidy reform. Alternative and more direct policy options could be pursued together with appropriate compensation mechanisms.

Recommendations:

1. The Council may wish to note that countries that have been successful market integrators have complemented trade liberalization with macroeconomic stability, including control of fiscal deficits and inflation, avoidance of overvalued exchange rates, improved tax regimes and strengthened financial sectors. It may encourage international financial institutions, other development agencies, and bilateral donors to play a major role in supporting countries on the path towards these policies, including through increased technical assistance and capacity-building.

2. The Council may further note that increased interdependence among national economies will require strengthened international cooperation and harmonization in the area of macroeconomic policies, environment, labour and health as well as in development cooperation policies, including *enhanced participation of developing countries in such governance mechanisms.*

3. The Council may stress the need for an international dialogue on these issues and consider devoting one of its high-level meetings with the Bretton Woods institutions and WTO, called for under General Assembly resolution 50/227, to this topic.

4. The Council may also request the Committee for Development Planning to study the coherence of development cooperation policies from the point of view of their overall impact, taking into account the ongoing work in this area, in order to develop approaches and modalities that the Council could consider at a subsequent coordination segment.

5. The Council could issue a call for an international dialogue on subsidies that could be initiated and stimulated, not only at the global but at the regional and local levels, with the support of organizations such as WTO, the Bretton Woods institutions and UNDP in cooperation with relevant specialized agencies. The Council could consider placing this issue on the agenda of a future high-level segment.

Marginalization*

33. The associated forces of globalization and liberalization have resulted in increased openness in economic relations, as well as in other dimensions of development. The world has become economically more competitive at the level of individuals, firms, countries and regions. As intended, this has benefited those in a position to take advantage of the new opportunities.

34. Increased flows of trade and capital have provided greater access to resources and higher growth in many countries, and have strengthened the global economy through a more efficient allocation of resources. Developing countries as a group have participated extensively in the acceleration of global integration. During the first half of the 1990s, their overall ratio of trade to GDP rose 1.2 percentage points a year, while their share of global FDI rose to two fifths.

35. However, there are wide disparities in global economic integration across developing countries. Many developing countries did not participate in the globalization of the world economy over the past decade, and a large divide now separates the least from the most integrated. Many low-income countries are among the least integrated and some have become even more marginalized during the past 10 years, experiencing both falling incomes and lower levels of participation in the world economy. For example, the ratio of trade to GDP fell in 44 of 93 developing countries over the past 10 years, while the ratio of foreign direct investment to GDP fell in more than a third. If current trends

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* A number of recommendations in the sections on official development assistance; external debt; and capital flows, investment and trade specifically address the issues relating to marginalization.

persist, many developing countries can expect to fall further behind developed and the better integrated developing countries in per capita GDP.

36. Left to their own devices, the forces of globalization and liberalization are likely to result in increased efficiency and concentration of wealth, rather than in greater equity and participation. The beneficial effects of these two forces are thus accompanied by the possibility of marginalization at many levels - global, national, local, group and individual.

37. At the global level, the least developed countries have long been recognized as being at risk of marginalization in the world economy. Many other countries in Africa, notably those south of the Sahara, are similarly challenged - they lack various elements in the physical, financial, human and institutional infrastructure necessary to enter and compete effectively in international markets. Structural difficulties also deter inflows of the FDI that is stimulating economic growth in some other developing countries and, more generally, perpetuate the dependence on a few highly volatile exports that afflicts many of these poorer countries. Domestic supply side constraints seriously limit export response to the trade liberalization efforts of the least developed countries and their ability to exploit market access potential in the wake of the Uruguay Round. In many cases, the difficulties are compounded by an unmanageable burden of external debt.

38. The experience of countries that have been most successful in attracting private capital flows suggests that official finance has played an important facilitating role in helping them establish the conditions necessary for such flows. These countries have typically relied on significant official finance during the two decades leading up to integration. Given the long gestation periods of investments in human resource and infrastructure development, as well as the investments needed to diversify their economies, Africa and the least developed countries are in need of increased ODA flows. Contrary to the commitments in the Programme of Action for the Least Developed Countries for the 1990s, ODA to these countries has been declining in real terms in recent years, which could not be compensated even if there were increased exports and greater FDI inflows. Structural difficulties also partly explain the meagre FDI flows to these countries. ODA will continue to be the most important component of their external financing.

Official development assistance

39. Since the end of the cold war the reordering of geopolitical priorities has led to sharp cuts in aid budgets and a shift away from long-term development and poverty reduction efforts at the very time that many developing countries have become more receptive to market-based reform. Some of the reduction in assistance relates to countries that lack access to private capital markets. Many of these countries have no realistic external financing alternative in the short to medium term. The slowdown in ODA is particularly worrisome because such flows are usually directed towards the development of the various forms of infrastructure that are required to participate in the globalization process and build the foundations for growth and development. Even in the unlikely event that private sources replace these lost flows in financial terms, they would be directed towards short-term commercially profitable ventures rather than

responding to essential needs calling for a longer time horizon. Sustained flows of official development assistance remain essential if Africa and the least developed countries are not to be further marginalized.

40. Following a sharp fall in 1993 and a partial recovery in 1994, ODA dropped by nearly 10 per cent in real terms in 1995 and fell again in 1996 to the lowest level in 10 years. Moreover, the composition of ODA has shifted, with a significant portion being used to fund emergency relief and peacekeeping activities and less directed towards long-term development needs.

41. The position is worse than it appears in one further respect, namely, the sizeable cut by bilateral donors in their commitments to multilateral concessional lending windows. During the period 1990-1995 multilateral aid disbursements cushioned the overall decline, rising from 26 per cent to 32 per cent of total aid disbursements. The outlook, however, is less promising, because while multilateral disbursements are rising, donor commitments are falling. For example, the donor commitments to the International Development Association (IDA), the World Bank's concessional lending arm, dropped by about $7 billion during the period 1994-1996. Because of the lag between donor commitments and disbursements, cash flows to IDA have not yet declined. But eventually they will, unless donors increase commitments.

42. ODA has retained its low-income focus as it should. The share of ODA going to low-income countries has remained constant: 69 per cent in 1990 and 70 per cent in 1995. There has been some redistribution of funds, however. Sub-Saharan Africa continues to take the largest share of ODA, about 35 per cent. In 1995, ODA to high-income countries fell significantly and now represents only a small fraction of the total.

43. The declining availability of ODA and bleak aid outlook is particularly worrisome for the least developed countries. The overwhelming dependence of these countries on ODA is likely to continue during the foreseeable future. The basic policy issues that the international community faces in this regard are: (a) how to improve aid allocations to the least developed countries and (b) how to enhance the quality and effectiveness of assistance. Unless these issues are adequately addressed, the long-term development objectives and the sustainability of policy reforms in the least developed countries will be jeopardized.

44. Concentrating ODA on low-income countries makes a focus on poverty reduction more likely. Aid directed to middle- or even high-income countries suggests that other objectives are being pursued. A larger portion of aid goes to low-income countries from multilateral sources than from bilateral sources. In 1995, 57 per cent of ODA from bilateral sources went to low-income recipients; the proportion from multilateral sources was 70 per cent. No multilateral ODA goes to high-income countries.

45. The declining trend in ODA budgets also reflects a certain crisis of confidence in aid as an instrument for promoting development. Unless this crisis is addressed squarely, it may be difficult to reverse the negative trend. The rationale for ODA needs to be reaffirmed and placed on a strong footing for

the years to come. This calls for a clear understanding and a sense of partnership and shared purpose between donors and recipients.

Recommendations:

1. The Council could promote an international understanding on the role of ODA based on a sense of partnership and shared purpose between donors and recipient countries. Donors must reaffirm and adhere to the long-term developmental purpose of ODA and commit themselves not to erode it by immediate, emergency needs or politically defined and other non-developmental priorities. Recipients should adhere to clearly targeted and more effective use of ODA. Donors and recipients must accept the need for greater selectivity in ODA allocations based on mutually agreed policy commitments and goals that are designed to address market failure, protect the poor and catalyse private flows. Donors must agree to improve the composition and quality of ODA to better match and serve its stated purposes. A new international understanding along these lines should underpin a real commitment to providing new and additional resources for development.

2. The Council may wish to emphasize the need for the international community to reverse the recent downward trend in official development assistance with a view to meeting the agreed targets for ODA flows, in particular to the least developed countries. More generally, the Council may wish to call upon all concerned to honour the commitments made in the mid-term review of the Implementation of the Programme of Action for the Least Developed Countries for the 1990s, in the mid-term review of the implementation of the United Nations New Agenda for the Development of Africa in the 1990s, in the Abidjan Declaration on African Diversification and in the African Diversification Fund for Agricultural Commodities.

3. The Council could encourage donors to renew their vision of aid as a means of helping poor countries create enabling environments for private sector development, and ensure that the resulting growth reaches all segments of society. In so doing, aid will also promote the economic and strategic interests of donor countries. These rationales require that aid support policy reform, infrastructure development, the provision of social services, and the creation of social safety nets. In this regard, the Council could reaffirm the importance of the 20/20 initiative as one means of securing adequate resources for basic social services for all. Implementation will require monitoring expenditures and donor contributions. The Council may wish to call for further efforts to ensure that internationally supported adjustment programmes, including Enhanced Structural Adjustment Facility (ESAF)-supported programmes, incorporate social safety measures and restructuring of public expenditure, including increases in expenditure related to primary education and primary health services, in line with the recommendations of the World Summit for Social Development.

4. The Council could express its concern that contributions for the eleventh replenishment of IDA are not adequate to support even current levels of lending. The Council may note that multilateral aid *disbursements have cushioned the overall decline in aid in the recent past, but this will not last as contributions to multilateral facilities have fallen off as well. The Council may stress the fact that it is essential that multilateral aid disbursements be maintained or increased.*

External debt

46. One of the specific obstacles to the development efforts of Africa and other low-income countries over the past decade - and hence a source of their marginalization - has been external debt. While most of the debt crises that emerged in the middle-income countries in the 1980s have been largely alleviated, serious problems remain in several low-income countries. Even with sound economic policies and the full application of the debt rescheduling arrangements of the past few years, these countries continue to face an unsustainable external debt situation. The resulting resource constraints have prevented them from implementing the national actions, including investments in human resource development, infrastructure and diversification, that are necessary to participate meaningfully in the global economy.

47. In order to address this problem, IMF and the World Bank have established the Heavily Indebted Poor Countries (HIPC) Debt Initiative.[6] The objective of this Initiative is to lower to sustainable levels the external debt of HIPCs with a strong track record of adjustment policies and thus enable them to exit from the debt rescheduling process. The Initiative entails the recognition by the international community that the external debt burden of many poor developing countries is severely impeding their development efforts and that some countries are unlikely to emerge from their development crises without such measures as are now to be made available. Removing the debt overhang is a condition necessary for successful reform, particularly in countries that must reinvigorate the private sector and stimulate domestic investment. Restoring country creditworthiness will take time and depend on the continued efforts of those countries to address their economic and social problems.

48. In November 1996, the World Bank set up a HIPC Trust Fund that is to be administered by IDA. The World Bank has set aside $500 million from net income as an initial contribution to the Trust Fund to meet its share of the debt relief needed, and several bilateral contributions have been received. At the World Bank/IMF meetings in April 1997, the World Bank approved a debt-relief package for Uganda, making it the first country to benefit from the Initiative. In February 1997, IMF established a Trust for Special ESAF Operations for the Heavily Indebted Poor Countries and Interim ESAF Operations. The contribution of IMF under the HIPC Initiative would mainly be in the form of grants, though highly concessional loans would be used to provide financing during the interim period to smooth heavy debt-service obligations. Discussions are ongoing, including with bilateral sources, to secure the resources required to finance the full costs of the Fund's participation in the Initiative. These decisions - together with the consent obtained from all ESAF Trust creditors - would allow IMF to transfer up to SDR 180 million from the ESAF Reserve Account to the ESAF-HIPC Trust.

49. The Initiative demonstrates that, once the political commitment is achieved, the international financial community can coordinate its efforts to

confront a fundamental, systemic cause of poverty and isolation. And because the Initiative requires the participation of all relevant creditors, debt relief efforts will have to continue to be closely coordinated. This Initiative has raised high expectations in the heavily indebted developing countries. It is therefore important to proceed to implement the Initiative as rapidly as possible.

Recommendations:

1. The Council could welcome the 1996 initiative of the Managing Director of the International Monetary Fund and the President of the World Bank, which was endorsed by the Interim Committee of IMF and the Development Committee of IMF and the World Bank, to resolve the debt problems of the heavily indebted poor countries and call upon the countries affected and the international community to work closely together to advance the implementation of the HIPC Initiative as rapidly as possible.

2. The Council may wish to call for an early agreement on the financing of the interim ESAF and the special ESAF operations under the HIPC Initiative and urge bilateral contributors to make available the resources necessary for the Initiative to be fully implemented.

3. The Council could call upon the Fund and the World Bank to interpret the criteria for eligibility for the HIPC Initiative flexibly and transparently so that the range of potentially eligible countries is sufficiently broad to resolve the debt problems of debt-distressed countries on a long-term basis.

Volatility and vulnerability

50. One possible consequence of the more highly liberalized international economic environment is the greater potential for international volatility in prices, not only of primary commodities but of other traded goods; international interest rates; or even key-currency exchange rates with rapid and large movements of capital.

51. The past two decades have witnessed the increased integration of financial markets as a result of rapid deregulation and liberalization of financial activities as well as rapid advances in communications technology. While this has increased the amounts and categories of financing potentially available to countries and entities throughout the world economy, so far only a small minority of countries and entities have actually achieved sustained access to this financing. In addition, this integration raises the premium on Governments to pursue sound macroeconomic policies to ensure the sustainability of flows. Nevertheless, integration also tends to increase the downside risk of a sudden reversal of financial flows for an individual country, as well as the possibility of spillover effects on others.

52. As the scale of foreign capital has increased in the financial markets of certain developing countries, these markets have become highly vulnerable to shifts in sentiment among international investors and fund managers, especially since an important part is of a short-term speculative nature. Sudden reversals

or reductions of such flows have threatened financial and macroeconomic stability, required painful adjustments in the recipient country and created spillovers in other emerging financial markets. On the other hand, volatility in international financial flows can also be caused by domestic policy volatility, which can be constrained by rule-based international regimes.

53. As countries liberalized capital account transactions, several of them witnessed bouts of more volatile financial inflows and outflows. Against this background of turbulence in some major emerging market economies in 1994/95, efforts have been made to strengthen surveillance, particularly with the aim of ensuring that, in a world of integrated and volatile capital markets, IMF would be better equipped to identify emerging crises at an early stage.

54. In order to strengthen the ability of IMF to respond to a member facing an external financial crisis and seeking assistance from the Fund, the IMF Executive Board, in September 1995, agreed on the elements of an Emergency Financing Mechanism (EFM). The essence of EFM is its exceptional procedures to facilitate rapid IMF Board approval of financial support while ensuring the conditionality necessary to warrant such support. EFM would be used in circumstances representing or threatening to give rise to a crisis in a member's external accounts requiring immediate response from the Fund. The potential for spillover or contagion effects would be an important consideration in a decision to activate EFM.

55. In order to ensure that IMF has sufficient resources to deal with an exceptional situation that poses a threat to the stability of the international monetary system, the IMF Executive Board, in January 1997, adopted a decision on New Arrangements to Borrow (NAB). The amount of resources potentially available under NAB is roughly $47 billion, double the amount that has been available under the General Arrangements to Borrow (GAB), and the number of potential participating countries or monetary authorities with the financial capacity to support the international monetary system has increased to 25, including a number of developing countries. The New Arrangements to Borrow will become effective when they are adhered to by potential participants with credit arrangements amounting to at least 85 per cent of the total, including the five participants with the largest credit arrangements. This will represent an important strengthening of the international monetary system.

56. Another important step taken to strengthen the surveillance capacity of IMF is the establishment in March 1996 of a Special Data Dissemination Standard for the voluntary dissemination of economic and financial data by member countries that have, or seek, access to international financial markets.

57. Many of the concerns regarding international financial instability are associated with its consequences for exchange rates. Of special importance in this context are the effects of the persistence for extended periods of exchange rates that are inconsistent with sustainable external payments positions. Such exchange-rate misalignments distort resource allocation through their impact on relative prices, and have perverse effects on activity, employment and the price level. They have effects similar to, or even stronger than, tariffs on trade flows since almost all decisions on production and trade are based on price signals, and exchange rates enter the prices of all internationally traded

goods. Perhaps the most damaging effect of exchange-rate misalignment is that it triggers protectionist measures that are not dismantled when exchange rates return to their normal levels. In this way, exchange rate instability poses a continuing threat to an open trading system.

58. Few of the major developing countries have adopted a largely or completely non-interventionist stance towards financial inflows. The majority has had recourse to intervention in foreign exchange markets to prevent currency appreciation and the emergence of unsustainable payment imbalances. However, where capital inflows are large relative to current account deficits, such intervention has created serious conflicts with domestic monetary policy objectives. When intervention is not sterilized, the rapid increases in the money supply threaten loss of control of monetary policy. Sterilization of intervention, on the other hand, results in an increased fiscal burden as it requires either a budget surplus or financing. These lead to higher interest rates and increased public debt, with adverse consequences for capital accumulation and social welfare.

59. More direct controls over capital inflows have also been used to reduce the vulnerability to international volatility. However, such measures run counter to the prevailing philosophy of financial deregulation and liberalization, and countries are often discouraged from resorting to such measures by their fear of being cut off from international financial markets. Nonetheless, discussions of market intervention have become increasingly nuanced, especially in the light of the instabilities that accompanied some of the deregulation measures.

60. There is considerable discussion of the need for new interventions in the international financial field. International cooperation in this area has been building in an ad hoc way, as the regulators in major financial market countries find that the institutions they supervise have increasingly important activities beyond their jurisdiction. Better supervision of international financial markets will reduce the vulnerability of financial institutions to fraud, mismanagement and excessive risk exposure. In turn, this will reduce the vulnerability of the non-financial users of the institutions. However, there is nothing in this to reduce the volatility of international financial flows per se.

61. Against the background of financial instability associated with banking system difficulties, there is wide recognition of the need for international action to improve and coordinate the regulatory and supervisory frameworks for financial systems. The Basle Committee on Banking Supervision has developed a set of Core Principles for effective banking supervision, which provide a valuable building block for these efforts. In response to an initiative at the Lyon Summit of the Group of Seven, a Working Party of the Group of Ten and emerging market economies is developing, with the support of all relevant institutions, a concerted international strategy to promote the establishment, adoption and implementation of sound principles and policies needed for financial stability.

Recommendations:

1. The Council may emphasize that against the background of increasing risk associated with financial instability, there is a widely recognized need for international action to improve and coordinate national regulatory frameworks for international financial transactions. It may welcome the initiatives taken by the Basle Committee on Banking Supervision, the IMF and the Working Party of the Group of Ten and emerging market economies to establish standards to strengthen the regulatory and supervisory mechanisms for banking and financial markets. It may note, however, that these are still limited in scope and do not cover all firms and actors in financial markets. More effective restraint of financial instability will require a more comprehensive international regulatory and supervisory regime. The Council could request IMF and the World Bank, together with other relevant institutions and groups, to explore ways of incorporating more fully all countries and other interested parties into the process of developing and implementing such a regime. The Council may request the Committee for Development Planning to examine these issues with a view to contributing to this process.

2. The Council could encourage IMF to fully exercise its role of overseeing the international monetary system to ensure its effective operation, inter alia, through symmetric surveillance of the macroeconomic policies of each of its members. In this regard, the Council could welcome the efforts undertaken since 1995 to strengthen surveillance, to ensure that IMF is better equipped to identify emerging crises at an early stage and to facilitate its rapid response to such crises.

3. The Council could also reiterate the importance of ensuring that IMF has sufficient resources to assist its members and encourage the timely conclusion of the general review of quotas and approval of a substantial increase of quotas. It could also call upon potential participants to ensure that the New Arrangements to Borrow become effective as soon as possible.

Capital flows, investment and trade

62. Most developing countries have liberalized their FDI alongside their trade regimes. Although most FDI and portfolio capital still flows to industrialized countries, an increasing proportion is going to developing countries. After declining in the 1980s, private capital flows increased dramatically, and to unprecedented levels, in the first half of the 1990s. Between 1987 and 1996, private capital flows to developing countries increased from $25 billion to $244 billion and their share of total FDI has increased from 23 per cent in 1990 to nearly 40 per cent in 1996. In 1993 FDI flows surpassed official development finance and in 1996 they were almost four times as much. Net portfolio flows have seen a similar trend: from a negative level until the late 1980s, they reached some $32 billion in 1995 and $45 billion in 1996. However, FDI and portfolio flows are highly concentrated, mostly in Asia and parts of Latin America. Between 1993 and 1995 a mere 10 countries received 76 per cent of all FDI in the developing world and only about 20 developing countries are today

considered creditworthy by international capital markets and banks. In recent years, Africa has received only 4 per cent of total net private flows.

63. Among the contributing factors to this surge in private flows are the high growth rates experienced by many developing countries, the spread of market reforms and, in particular, the deregulation of private capital flows, the liberalization of world trade, the rise of global institutional investors and the accelerating capitalization of emerging markets and their integration into world financial markets. Local participation has been a common characteristic. Macroeconomic stability, market size, infrastructure endowments and the presence of skilled manpower are all important in shaping the locational choices firms make when investing abroad. A key lesson that can be drawn is that markets matter and gainful participation in global markets requires carefully tailored policies that promote integration into the global economy. A key question is, what can be done to foster more stable and more long-term investment and capital flows to a widening circle of developing countries?

64. While Governments may have assisted in making globalization possible by reducing legal and administrative barriers to flows between countries and regions, the main actors in the process have been mostly private enterprises, largely based in developed countries, although, in recent years, enterprises from newly industrialized countries have become active in other developing countries. Transnational corporations are overwhelmingly responsible for the advances in technology and the growth in trade and financial flows that form the backbone of globalization. However, within the developing world, their activities have been heavily concentrated in a small number of countries. A challenge to the international community in creating an enabling environment for development lies in inducing transnational corporations to diversify their activities across a broader range of developing countries.

65. Foreign direct investment provides a number of benefits to developing countries. Hosting affiliates of transnational corporations provides non-debt-creating capital inflows, as well as potential access to advanced foreign technology, managerial skills and foreign markets. It can also soften the balance-of-payments constraint, add to employment and have other positive direct and indirect linkage effects on the economy. These benefits greatly depend on the degree of competition they face in domestic markets. Thus, the benefits do not come automatically and policies designed to achieve such benefits may run into conflict with other objectives regarding trade and development.

66. A conflict between free trade and attracting FDI may arise in cases where FDI is primarily motivated by an effort to circumvent trade barriers. Indeed, some countries with restrictive trade regimes have been able to attract considerable FDI because it provided the only means for foreign firms to access domestic markets. Such protection, in turn, can benefit transnational corporations once they establish themselves in domestic markets. They may then also exert some pressure for protection from external competition, so that protectionism in such instances may be closely associated with policies to attract FDI.

67. Given the importance that FDI has gained, an increasing number of regional economic agreements address investment matters. There are also several

multilateral investment agreements, dealing mostly with specific subjects. A more comprehensive agreement is being negotiated between countries members of the Organisation for Economic Cooperation and Development (OECD), which will be open to non-members of OECD, once it is concluded. The WTO Ministerial Conference (Singapore, December 1996), agreed to establish a working group to examine the relationship between trade and investment, on the understanding that this work would not prejudge whether negotiations would be initiated in the future.

68. Another concern in the global economic system is the possibility that enhanced competition between States for FDI, if carried too far, would result in loss of benefits to host countries as the lion's share of the gains could accrue to foreign firms. The costs to the host country of providing financial, fiscal and other indirect incentives could turn out to be greater than the net gains of FDI. Moreover, competition leads to cost-minimization strategies which could have an adverse effect on wages and on levels and conditions of employment in enterprises. Such a strategy might generate some short-term benefits for a particular country but would become counter-productive if all countries adopted it. Social costs - in terms of job security, less protection for children and families and increased income dispersion - may also negatively affect consumer demand and therefore employment. Another way through which pressure on wages and labour standards could operate is the weakening of the regulatory capacity of Governments in the face of heightened international competition. An important policy conclusion is that rather than attracting FDI through increased incentives, it may be wiser in the long run to rely on a sound framework of policies and development strategies seeking greater integration in the world economy.

69. The key trade issues that affect development and that need to be addressed within the context of WTO include increased access for developing countries in areas of their comparative advantage, tariff escalation, preference-erosion and the misuse of anti-dumping measures and countervailing duties. The growing trend towards regional trading arrangements needs to be closely monitored, as agreed in WTO, to ensure that it is consistent with and complementary to an open multilateral trading system. The potential negative effects of trade liberalization on the least developed and net food importing countries should be mitigated by increased financial and technical assistance.

Recommendations:

1. The Council may wish to note the important agreement reached by the Interim Committee of IMF, at its meeting in April 1997, that the Fund's Articles should be amended to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements; the scope of such jurisdiction would need to be carefully defined and sufficient flexibility should be allowed through transitional provisions and approval policies. The Council may call for further work to be undertaken, taking into account the need for flexibility under specific circumstances and such conditions as a sustainable macroeconomic framework, well-capitalized banking institutions and clearly defined legal and institutional arrangements.

2. In the light of the increasing importance of foreign direct investment in the world economy, the Council may wish to invite UNCTAD, WTO and the other organizations concerned to study the most appropriate ways of promoting rule-based investment regimes.

3. Beyond the standard prescriptions for Governments on how to attract FDI and portfolio flows over the long term, there is a need to create a strong institutional and information base for investors and fund managers to draw upon in their decision-making. Among other things, this calls for further study of recent experience and best practices, greater exploration of the social services sector for FDI, improved statistical services and standardization in corporate disclosure, accounting and settlement. The Council could encourage the institutions concerned, for example, UNCTAD, UNDP, the World Bank and IMF as well as the Committee for Development Planning, to undertake further work in some of these areas and assist developing countries through capacity-building.

4. The Council may wish to call for continued concerted action to remove lingering, disguised and other obstacles to free and open trade. Particular efforts are required in the area of agriculture, which remains highly protected and subsidized, and other sectors of interest to developing countries, including textiles and clothing, within the context of the full implementation of the outcome of the Uruguay Round.

5. The Council may emphasize that the international community needs to devote greater efforts to increase the market access of least developed countries in particular. The Council could stress the importance of fully and expeditiously implementing the Marrakesh Declaration, the Ministerial Decision on Measures in Favour of Least Developed Countries and the Ministerial Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least Developed and Net Food-Importing Developing Countries.[7]

6. The Council could affirm the importance of international efforts to strengthen the capacity of developing countries to take advantage of the multilateral trading system and existing favourable provisions in the WTO Final Act. It is also important that developing countries are well informed and equal partners in processes leading to trade negotiations in sectors of interest to them, including agriculture.

7. The Council may wish to request the Committee for Development Planning to examine the extent to which trade problems facing the least developed and other disadvantaged countries could be addressed in the aftermath of both the Uruguay Round and other liberalization measures, and to propose remedial actions.

8. The Council may wish to note that supply capacities are lacking in many developing countries, thus hampering their ability to reap the potential benefits of trade liberalization and FDI. The development of these capacities continues to require technical and economic cooperation of various forms. The Council may call for strengthening the supply capacity of exportable goods and services in least developed countries in *particular. The Council could consider encouraging the United Nations system, including IMF and the World Bank, and WTO to coordinate their action in this area, and urge all countries to participate in the forthcoming High-Level Meeting on Integrated Initiatives for Least Developed Countries, to be organized by WTO, UNCTAD, the International Trade Centre, the World Bank and IMF on 27 and 28 October 1997.*

9. The Council may wish to note that work is under way in WTO and UNCTAD in the areas of trade, investment and competition, and invite these organizations to cooperate in studying all the implications of the relationship between trade and investment to lay the basis for developing sound and equitable rules in this area. In addition, UNCTAD could be invited to pursue and advance its work on the linkages between trade and competition policies.

Notes

[1] See also Economic and Social Council resolution 1996/43.

[2] IMF Survey, 14 October 1996, p. 327.

[3] See The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts (Geneva, GATT secretariat publication, Sales No. GATT/1994-4), in particular the Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking.

[4] See OECD, Development Assistance Committee, Shaping the 21st Century: The Contribution of Development Cooperation (Paris, May 1996).

[5] André P. G. de Moor, "Key issues in subsidy policies and strategies for reform" (Institute for Research on Public Expenditure, the Netherlands).

[6] See, for example, communiqué of the Joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries, Washington, D.C., 30 September 1996; communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund (Press release No. 96, 19 September 1996); and World Bank, "The Heavily Indebted Poor Countries (HIPC) Debt Initiative", Annual Meetings Backgrounder (Washington, D.C., 24 September 1996).

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