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THE RISE OF THE SOUTH AND NEW PATHS OF DEVELOPMENT IN THE 21ST CENTURY

BACKGROUND PAPER

SOUTH – SOUTH FINANCIAL COOPERATION

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BACKGROUND PAPER NO. 7

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SOUTH – SOUTH FINANCIAL COOPERATION

I Introduction

This paper will examine South-South financial cooperation, in the context of a new development strategy for Least Developed Countries (LDCs).

In the last decade, South-South financial links have become far more important, as the significance of developing economies in the world economy has risen sharply, as have their levels of foreign exchange reserves and domestic savings. The increased importance of South-South financial links, relative to North-South financial links, has been further increased, due to the impact of the global financial crisis, which has weakened the ability and appetite of Northern countries for North-South cooperation. In the past, a key advantage of - for example – including developed countries in the membership of regional development banks was their ability to contribute very significant resources that helped capitalize these banks and gave access to global capital markets. This is now changing quite significantly. However, at the time of writing Northern private capital flows to developing countries were surging, as higher yields and higher growth prospects in the South than in the North, at least temporarily, encouraged such flows. Nevertheless, such flows are heavily concentrated in the more creditworthy countries and are potentially reversible.

In this paper, we will focus mainly on how the potential for greater, and even more developmentally effective, South-South financial links than those which now exist, can be realized. For this purpose, we will make a number of fairly broad, but also very concrete, policy and institutional suggestions. This will include greater use of developing country resources (especially foreign exchange reserves and Sovereign Wealth Fund assets) to fund long term investment in least developed countries (LDCs), as well as in other developing economies. The best mechanism to do that would be to create new (or expand where they exist) developing country owned regional development banks (RDBs). We will discuss this idea in detail below.

In the next section (II), we will briefly discuss the policy and analytical context. A key idea is that the financial sector (both domestic, regional and international) should be at the service of the real economy; in particular, in the case of LDCs, it should be at the service of

a long term development strategy, that will hopefully deliver inclusive, stable and sustainable development for these countries.

Section III will discuss in some detail the proposal of using foreign exchange reserves and particularly SWF assets for long-term investment in LDCs, especially via South-South development banks.

Section IV would briefly explore some innovative ideas for more general financing (both North-South and South-South), of particular relevance for LDCs. These would include; a) modification of compensatory financing in the light of increasingly frequent external shocks, and possible contributions by Southern countries and b) more development friendly modalities of lending, both private and public, such as via GDP-linked bonds or counter-cyclical official loans. The former could be of particular interest to Islamic Southern; countries, as they seem very consistent with Islamic finance.

Section V will explore some ideas at a national level, on how domestic financial systems in LDCs should best serve development, whilst also supporting financial stability.

II The policy and analytical context

In the Introduction, we briefly discussed the growing importance of South-South financial links and the great potential for expanding those links. In particular, the level of foreign exchange reserves of developing and emerging economies has been rapidly increasing and reached the massive amount of US$6.1 trillion (Source: IMF, see also Table 1 and Graph 1 below)); additionally, the assets of Sovereign Wealth Funds (SWFs), most of which are owned by developing and emerging countries reached around US$4.3 trillion. Of these, around $3.5 trillion are owned by developing and emerging economies. Particularly the SWFs have very long term liabilities (as they are invested often for future generations). As a consequence, they are an ideal source of long-term development finance for investing in LDCs; one potentially very good channel to do that, as developed below, would be through expanded or new developing country owned South-South banks.

A second important element to consider is the crucial role of public development financing, and specifically of development banks, at the international, regional and national level.

For a long period, the increased influence of neo-classical thinking in economics emphasized that private banking (preferably dominated by international private banks) and private capital flows were the best modality for financing development. As a result, the role of national, regional and international public development banks was downgraded where they existed and new ones discouraged; the exceptions were the highly successful development banks in countries like Brazil (BNDES especially), India and China, which have played such a positive role in supporting those countries' development.

There are basically three reasons why public development banks have a fundamental role to play, at the national, regional and international level, particularly – but not only – in poor developing countries, like LDCs. These reasons have become far clearer as a result of the global financial crisis.

1) The first set of reasons relate to important market imperfections and market gaps. For example, international private flows tend not to finance the poorest countries, a crucial market gap. Furthermore, they tend not to finance infrastructure, especially in poorer countries, as they consider longer maturities more risky than short ones. This is also naturally the case for investment in the green economy, where projects often are riskier and require longer maturities; often they also require some element of subsidy, due to social externalities, not reflected in purely commercial evaluations. A final example of market imperfections is the relative unwillingness of private finance to fund SME investment and working capital.

   In all these areas and sectors, (as well as others) public development banks can – and do – lend, covering market gaps and imperfections. Where subsidies are needed (e.g. certain green investment, lending to LDCs in general), grants can be used (via blending) for subsidized loans from development banks. For example, in Europe, the highly successful European Investment Bank, the EIB – owned by EU member governments – blends grants with loans, to lend for example to green projects, to SMEs in Europe and to poor developing countries, including LDCs.

2) The second set of reasons why public development banks are particularly important is their ability and willingness to do counter-cyclical lending, when private lending declines, and when other shocks happen. This role not only became crucial for sustaining growth in developing economies during the global financial crisis, as MDBs,

RDBs and NDB increased their lending significantly (see Griffith-Jones and Tyson, 2011) but has finally become widely recognized as a crucial function of public development banks (see Ocampo, Griffith-Jones et al, 2010). This recognizes that – as many previous crises, as well as the recent global financial crisis show – it is not just important to provide additional liquidity during crises, but also to provide significant official long-term finance, when private finance dries up during and after crises; this is important to maintain funding of existing and important new investment projects, both in the productive and social sectors, crucial for long-term development.

3) Perhaps the most important reason why development banks are crucial is that they (especially at the regional and national level) can help support a long term vision of a dynamic, equitable and sustainable economic development model.

We highlight below four major elements for such a development model. First is having a development model based on the expansion of a diversified productive base. Second is establishing the most effective insertion into the new international economy so as to maximize development impact of links with the most dynamic economies. Third is combining this international insertion with greater deepening of domestic and regional markets. Last is to meet the challenge of development which takes into account ecological constraints.

In a broader sense, there is a clear need for a national development state, that will articulate an integrated vision of long term development in LDCs, including the diversification and expansion of the economy's productive capacities.

A second key challenge for national and regional public development banks is how best to support a strategy that effectively inserts LDC countries in the new international context of dynamic growth in Asia, and especially in China, compared to developed economies. The challenge for LDCs in particular is to ensure that this insertion is not only limited to exports of commodities but develops higher-value engagement such as, for example, commodity processing or industrial products. This implies identifying products and sectors in which LDCs could have a dynamic competitive advantage. Such a strategy implies both identifying market niches and designing a joint public-private sector long term strategy to support relevant enterprises and sectors. Public national and regional development banks have a very

key role to play in such a strategy by providing long term finance especially in new sectors, processes and technologies.

A third broad question relates to the extent to which development strategies should continue to rely, as they did in the recent past, on export-led growth or whether they should evolve to focus more on domestic market growth. This clearly depends on how the world economy will evolve, for which there are two main scenarios. One scenario would be a continuation of the rapid recovery of trade that started in mid-2009, with a return to the trend of recent decades where world trade is more dynamic than world GDP. Second, there could be a scenario where trade does not recover and is not particularly dynamic. Many observers think that the second outcome is quite likely. In such a scenario, the best development strategy may be a return to *inward*-looking strategies focused on the dynamism of domestic markets. A complement to such policies could be a strategy of income redistribution, which would expand domestic markets. It is also interesting to mention that the Keynesian policies that have been essential for recovery from the Global Financial Crisis in many developing countries were de-facto inward-looking policies. A transition towards more inward-looking strategies is of course easier for large countries, like Brazil or South Africa. For smaller countries, this would imply that regional economic integration processes may have to play a more important role in the future, to create "expanded domestic markets" (Ocampo, Griffith-Jones, op cit) . As the early European experience shows, the role of a large public regional development bank, in the European case the EIB, can - and needs to - play key roles in supporting such integration processes, for example by helping finance crucial regional infrastructure.

A fourth element in a new development strategy for LDCs implies achieving a reduction in climate change risks and ecological scarcities both nationally and regionally. In the words of the UN Secretary General Preparatory Report to the 2012 United Nations Conference on Sustainable Development, the aim is an economy that is "low-carbon, resource efficient and socially inclusive." United Nations Environment Program ("UNEP") simulations indicate that a 10% reallocation of investment globally to "green investment" could result in significant long-term growth gains as natural resources are retained and replenished. The UNEP also

report other advantages important to poverty alleviation and more equitable income distribution, including from the greater labour intensity inherent in "green investments" and gains in small-scale farming. Such an approach would complement the strategy of deepening of domestic and regional markets. In addition "green investments" would reduce the negative risks associated with climate change, though the impact of LDCs' emissions on climate change is quite small, as proportion of global emissions. Furthermore, investment in research and development and technology transfers could help LDCs be able to gain international competitiveness as the competing global economies shift to more efficient low carbon technologies and may present a unique "leap frogging" opportunity to switch directly to cutting-edge technology. Critical areas of investments include public transport, renewable energy and sustainable agriculture, especially of small farmers, as well as water and sanitation.

Regional and national public development banks can play a critical role in such investments as they require scale and long term financing as some of this investment, for example in green infrastructure and energy, is large and will only become profitable after a long period. Through specific finance techniques, private investment confidence can also be encouraged by financing from development banks.

Furthermore, time-limited and transparent subsidies to support introducing green technologies not yet profitable in purely commercial terms may be ideally implemented by national and regional development banks. This could include channelling global funds dedicated to introducing such technologies into LDCs. Similarly, South-South regional development banks could help transfer technologies from relatively more advanced developing countries and regions to poorer ones, thus pursuing both a greener economy and greater economic development.

The role of a national or regional development bank needs to be therefore defined in the context of a vision of a development strategy that will lead to more sustainable, equitable and rapid growth. The scale, the sectorial priorities and the instruments of such a development bank need to be designed to serve this vision of development strategy. The potential - and the need for – regional and national development banks

to play a critical role in developing countries, and especially in the LDCs, is therefore very clear.

III Transforming long-term assets into long term investment in LDCs; the role of South-South RDBs

The traditional analysis was that capital would flow from developed, capital rich countries to poorer, capital poorer countries. In fact, this has never quite been the case, as net capital transfers from developing countries to developed ones have often been the rule, rather than the exception.

In particular, in the last decade, many developing countries have increased their domestic savings significantly; furthermore, they have accumulated vast foreign exchange reserves, on a historically unprecedented scale, part of which are invested in their Sovereign Wealth Funds (SWFs).

Such high levels of foreign exchange reserves and SWFs have some undesirable consequences – at a national level, especially for poor countries like LDCs, high reserves have a high opportunity cost in terms of development spending and imports foregone; at a global level, excessive reserves of developing countries have the unintended consequence of contributing to global imbalances.

However, they also have a major positive effect, and potential, for South-South financial links and cooperation.

In what follows, we will first outline the level of developing country reserves and SWFs; we will then describe briefly the origins of different SWFs; finally we will analyse in some detail how a very small proportion of the long term foreign exchange assets (especially those in SWFs) could be very fruitfully allocated to investment in South-South regional development banks, or more ambitiously in one South-South bank, that could lend across the developing world; it would be especially valuable for LDCs.

One caveat should be made. There are other forms of South-South financial cooperation and links that exist and/or can be encouraged. These include South-South FDI (for long term flows), as well as regional monetary cooperation, such as the Chiang Mai initiative in Asia. We focus here on South-South development banks, as these would be so crucial for financing the long term investment essential to support long term development

in LDCs. This would be in particular contrast with the far more short term funding provided by international capital markets, and which are so badly suited to finance long term development.

A. The accumulation of foreign exchange reserves and the rise of SWFs

A remarkable feature of the international financial system in the past decade has been the worldwide rapid accumulation of foreign exchange reserves by developing and emerging countries. Based on IMF data, we can see that between December 2001 and end 2010, global reserves quadrupled, (see Table 1 and Graph 1).The bulk of the increase has concentrated in the developing world: developing countries as a whole accounted for more than 80 percent of global reserve accumulation during this period, and their reserves approached US$6.1 trillion by end 2010.

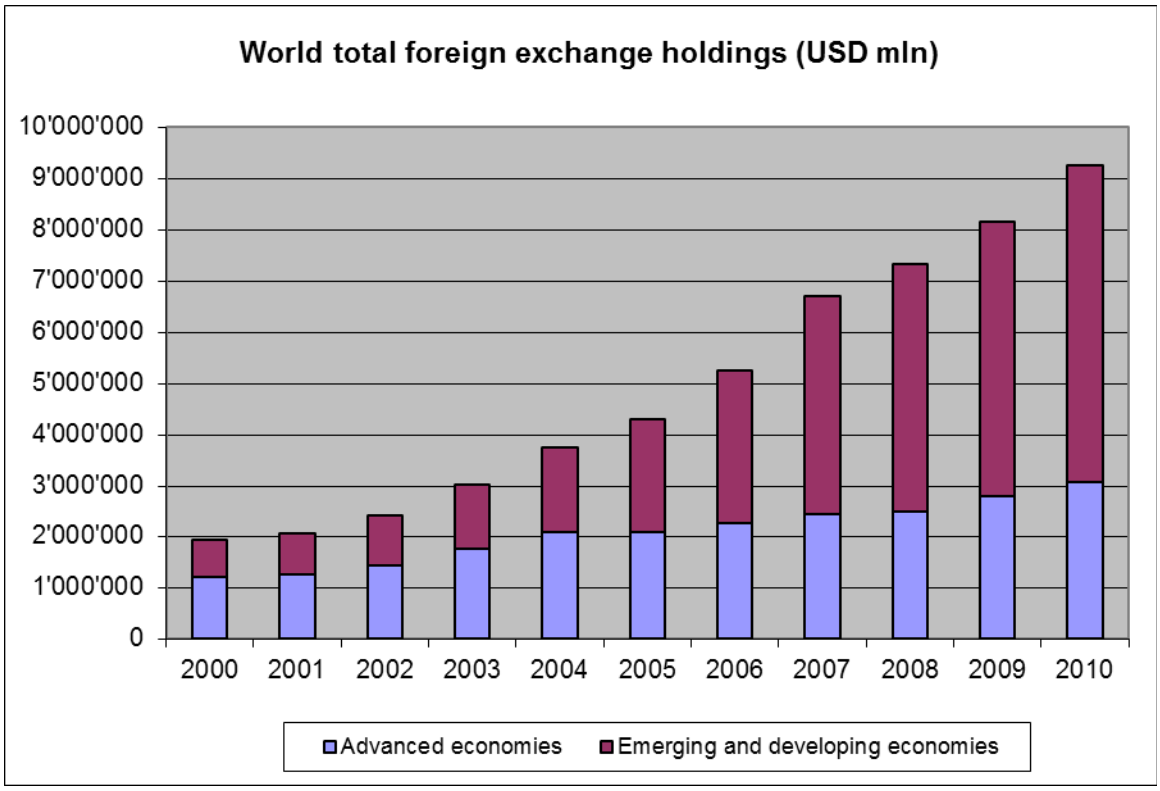
The extraordinary process of reserve accumulation in the 2003 -2010 period is without parallel in recent history; yet it does not tell the whole story. In fact, the total of US$6.1 trillion underestimates the actual increase of foreign exchange assets, as an important part of those assets in some areas of the world has been accumulated in SWFs, which tend to be run autonomously from traditional reserve management by central banks and/or finance ministries. According to research by IMF International Financial Services, SWFs across the world are estimated to have about US$4.3 trillion of international assets under management at the end of 2010.

Table 1: Level of Official Foreign Exchange Reserves (US $ million)

	2000	2005	2006	2007	2008	2009	2010
World Total	1,936,282	4,320,126	5,251,437	6,699,519	7,337,383	8,162,520	9,258,179
Advanced economies	1,217,235	2,078,708	2,252,743	2,432,420	2,491,405	2,778,837	3,092,790
Emerging and developing economies	719,048	2,241,418	2,998,694	4,267,100	4,845,978	5,383,683	6,165,389

Source: IMF

Graph 1: World total foreign exchange holdings (USDmln)



Source: IMF

The main reason behind the accumulation of foreign assets in SWFs, as noted by Aizenman and Glick (2007), is the boom in commodity prices, particularly oil. Oil-producing countries' SWFs account for nearly three-quarters of total assets under management by these funds. A second reason for the development of SWFs advanced by Aizenman and Glick (op cit) is the hoarding of international assets by non-commodity-exporting countries that are running persistent current account surpluses. Some countries seem to have more reserves than needed for precautionary motives, and have transferred part of them to special investment vehicles to maximize their returns. This is the case of East Asian countries, which have combined SWFs in excess of US$800 billion, to be added to their massive foreign exchange reserves.

SWFs can be broadly categorized into two main types: savings and stabilization funds. Savings funds are intended as permanent funds and are generally associated with non-renewable natural resources. They create a store of wealth for future generations so that they can benefit from the resources after their depletion. A stabilization fund is a

mechanism designed to reduce the impact of volatile fiscal revenues and/or foreign exchange receipts, linked to the pro-cyclical pattern of export prices or volumes. Stabilization funds often take the form of contingent funds, which accumulate resources when government revenues or the price of exports is high (above some threshold) and pay when they are low. These stabilization funds have shown themselves as very valuable to developing countries during the global financial crisis.

B. The rationale for reserve accumulation

A first school of thought contends that efforts by Asian countries to maintain or enhance export competitiveness in the context of an export-led growth model has led them to run massive current account surpluses, the main counterpart of which is, at the world level, the U.S. deficit.

However, although the "competitiveness" motives of foreign exchange reserve accumulation, as well as the absence of appropriate coordination mechanisms for exchange rate policies in export-led economies may be part of the explanation, many see “self-insurance” as the main motive, especially in the initial stages for foreign exchange reserve accumulation.

Indeed, there is clear evidence that the large accumulation of developing countries' foreign exchange reserves started after the series of large and costly crises, particularly the Asian one. It was, therefore, a rational response of each country to self-insure against the risks of deep financial integration, particularly the growing exposure to financial instability.

Thus, the spread of financial globalization to developing countries, reflected in their greater financial openness, and the growth of banking systems and financial markets, explain much of the increase in foreign exchange reserves of these countries.

An important and interesting question posed by several authors including Rodrik (2006), is why developing countries protected themselves from financial instability by increasing reserves rather than by reducing financial integration - introducing, for example, prudential capital account regulations. Indeed, as Ocampo (2007/08) has argued, self-insurance and its associated costs destroy, in a sense, the rationale for capital inflows in the first place, which is to transfer resources from richer to poorer and supposedly capital scarce

developing countries. It also implies that the justification of capital account liberalization as a means to diversify risks is clearly insufficient.

In this regard, it is useful to recall that countries that have liberalized their capital account less or more slowly (for example, India and China) or have introduced precautionary regulations on the capital account (e.g., Chile and Malaysia) have been far less prone to crises and their massive costs. This has been confirmed by the experience of the global financial crisis, when again China and India were able to avoid a crisis and maintain high growth. Therefore, prudential capital account regulations could reduce the costs of self-insurance. It is encouraging that institutions like the IMF, long-term proponents of capital account liberalization, have recently become far more open to capital controls.

Interestingly, the current turbulence in the developed world could lead to regulations in the rich world and globally that could facilitate greater control of speculative flows in and out of developing countries and thus reduce the need to accumulate reserves for self-insurance purposes. It is important for developing countries to participate actively in the ongoing debate on post global financial crisis regulations (facilitated somewhat by the fact that key regulatory international bodies have become G20 rather than G10 bodies) and carefully monitor its results and implications for their own regulations. It is key that the voice of LDCs, not currently represented in those G-20 bodies, is included in them, so their particular concerns and needs are represented in discussions, and especially in rule-making.

C. The broader context

When understanding the rationale for SWFs, it is important to start with the *current* account, as well as the underlying reasons for a current account surplus. If there is no current account surplus, it is difficult to rationalize the creation of SWFs. Indeed, were a SWF merely created on the basis of "borrowed reserves" -or, more broadly, "borrowed liquidity"—we can think of it really as a form of financial intermediation, as it would not involve really the management of *net* foreign exchange assets. As we will see, the accumulation of such borrowed funds in a regional or sub-regional development bank, especially a South-South one could make sense under those circumstances, but not a SWF as such. Even more clearly, regional or sub-regional development banks can be created from

resources generated from current account surpluses, especially if these have a clear permanent part in them.

Based on these preliminary considerations, we can differentiate four major motives for the accumulation of net foreign exchange assets. This affects the type of use which such assets could best be utilized for.

The first can be called the *wealth substitution motive*. In this case, there is a current account surplus that results from the exploitation of a non-renewable natural resource.

A second motive could be called the *resilient surplus motive* (with the surplus referring to the current account). The term "structural" could also be used, if we borrow from the Latin American literature of the 1950s (where it was applied to deficits rather than surpluses). The issue here is the tendency of some non-natural resource based economies to run current account surpluses that are fairly resilient to growth and even to exchange rate appreciation. Cases of this type are all East Asian, with China being the leading example.

The third may be called the *counter-cyclical motive*. We must differentiate, however, between two entirely different situations. The first case relates to cyclical swings in real exports (volumes) associated with foreign business cycles (global or of the relevant trading partners). The second, and the most important recently, is associated with cyclical swings in external prices, particularly commodity prices.

The fourth can be called the strict *self-insurance motive*, which we could argue applies when the source of the abundance of foreign exchange is the capital rather than the current account. Since capital flows are strongly pro-cyclical for developing countries, the problems are the risks of capital flow reversibility.

Table 2 summarizes in a simple table the basic motivations for the accumulation of foreign exchange assets, differentiating two dimensions: the source of the boom (a long-term or short-term current account surplus, or net capital inflows), and the role played by commodities vs. other factors influencing foreign exchange abundance.

Table 2: Basic motivation for the accumulation of foreign exchange assets by developing countries

	Long-term Current account Surplus	Short-term Current account Surplus	Capital flows
Commodities	Wealth substitution	Counter-cyclical (prices)	
Non-commodities	Resilient surplus	Counter-cyclical (volumes)	Self-insurance

Source: Griffith-Jones and Ocampo (2009), paper on which this section draws

Precisely because commodity prices and capital flows are pro-cyclical, there are many interactions among the different motives.

D. Why are South-South regional and sub-regional development banks desirable?

There are a number of reasons why developing, or South-South, owned RDBs and SDRBs are desirable.

a) Allow a strong voice to developing country borrowers, as well as a greater sense of regional ownership and control. This is illustrated by the case of institutions like the Corporacion Andina de Fomento (CAF) called Andean Development Corporation in English, where countries are both clients and shareholders.

b) Regional and sub-regional development banks seem more able to rely on informal peer pressure rather than imposing conditionality. This further allows disbursements of resources in a far more timely and flexible manner. In any case any conditionality reflects more the experience of successful developing countries, rather than preferences of developed countries. The special relationship between regional or sub-regional development banks and member countries encourage countries, even in difficult times to continue servicing their debt to *their* bank helping give it strong preferred-creditor status. This can enhance its credit rating well above that of its member countries.

c) Regional or sub-regional development banks are particularly valuable for small and medium sized countries, unable to carry much influence in global institutions, and with very limited power to negotiate with large global institutions. Their voice can be far better heard

and their needs better met by regional or sub-regional development banks. Furthermore, competition between two or more kinds of organizations, e.g. sub-regional, regional and global, for the provision of development bank services seems to be the best modality, as it provides small and medium sized countries with alternatives to finance development (Ocampo 2006). This is particularly valuable if RDBs are only Southern owned, in contrast with North-South institutions, as the dominant development paradigms they will be assuming will be different, giving more policy space for LDCs to choose their development strategy.

d) Information asymmetries may be far smaller at the regional level, given proximity as well as close economic and other links. Regional institutions may better share successful developing country experience. Regional development banks' (especially South-South ones) ability to transmit and use region specific knowledge can make them particularly helpful to countries designing policies most appropriate to their economic needs and political constraints.

e) Regional institutions may be better placed to respond to regional needs and demands, as well as potentially be more effective in providing regional public goods, especially those requiring large initial investments and regional coordination mechanisms. Important examples are: 1) financing regional cross-border infrastructure and 2) coordinating and helping finance regional efforts, at technological innovation, university education and others. (see also Griffith-Jones et al, 2009, for a more detailed discussion of this and the above points).

E. How South-South RDBs can be funded?

As we argued above that there can be a significant expansion of lending by existing regional development banks or by new ones, which are owned by developing countries. This is due to the large pool of foreign exchange reserves which developing countries have acquired, that extend clearly beyond their immediate liquidity needs, as reflected in the increased creation and large scale of sovereign wealth funds. It would be a very small proportion of the SWF assets, that we propose could be used for this purpose.

We will provide here preliminary calculations, which show the feasibility of a significant expansion of developing country owned RDBs funded by a very small proportion of total developing countries' SWFs. We will assume that the ratio between paid-in capital and level of annual loans would be approximately 2.4, similar to the ratio of CAF, one of the few South-South banks, that has been in existence for a long period, which is owned mainly by the Andean countries of Latin America. This ratio is calculated by dividing CAF annual loans by the level of paid-in capital. This is a conservative estimate to take account of relatively lower ratings of developing countries than those of developed countries. It is thus far lower than the same ratio for the European Investment Bank (EIB), as that bank has just developed country members. Indeed as surplus developing country ratings have been improving, and tend to be higher than CAF average ratings, this ratio may be somewhat conservative.

Table 3:Developing and emerging country SWFs assets, (March 2011); their origin

Country	Fund Name	Assets $Billion	Inception	Origin
UAE – Abu Dhabi	Abu Dhabi Investment Authority	$627.0	1976	Oil
Saudi Arabia	SAMA Foreign Holdings	$439.1	n/a	Oil
China	SAFE Investment Company	$347.1**	1997	Non-Commodity
China	China Investment Corporation	$332.4	2007	Non-Commodity
China – Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$292.3	1993	Non-Commodity
Kuwait	Kuwait Investment Authority	$260	1953	Oil
Singapore	Government of Singapore Investment Corporation	$247.5	1981	Non-Commodity
China	National Social Security Fund	$146.5	2000	Non-Commodity
Singapore	Temasek Holdings	$145.3	1974	Non-Commodity
Russia	National Welfare Fund	$142.5*	2008	Oil
Qatar	Qatar Investment Authority	$85	2005	Oil
Libya	Libyan Investment Authority	$70	2006	Oil
Algeria	Revenue Regulation Fund	$56.7	2000	Oil
UAE – Abu Dhabi	International Petroleum Investment Company	$48.2	1984	Oil
Kazakhstan	Kazakhstan National Fund	$38.6	2000	Oil
South Korea	Korea Investment Corporation	$37	2005	Non-

				Commodity
Malaysia	Khazanah Nasional	$36.8	1993	Non-Commodity
Brunei	Brunei Investment Agency	$30	1983	Oil
Iran	Oil Stabilisation Fund	$23	1999	Oil
Chile	Social and Economic Stabilization Fund	$21.8	1985	Copper
Azerbaijan	State Oil Fund	$21.7	1999	Oil
UAE – Dubai	Investment Corporation of Dubai	$19.6	2006	Oil
US – New Mexico	New Mexico State Investment Council	$13.8	1958	Non-Commodity
UAE – Abu Dhabi	Mubadala Development Company	$13.3	2002	Oil
Bahrain	Mumtalakat Holding Company	$9.1	2006	Oil
Brazil	Sovereign Fund of Brazil	$8.6	2009	Non-Commodity
Oman	State General Reserve Fund	$8.2	1980	Oil & Gas
Botswana	Pula Fund	$6.9	1994	Diamonds & Minerals
East Timor	Timor-Leste Petroleum Fund	$6.3	2005	Oil & Gas
Mexico	Oil Revenues Stabilization Fund of Mexico	$6.0	2000	Oil
Saudi Arabia	Public Investment Fund	$5.3	2008	Oil
China	China-Africa Development Fund	$5.0	2007	Non-Commodity
Trinidad & Tobago	Heritage and Stabilization Fund	$2.9	2000	Oil
UAE – Ras Al Khaimah	RAK Investment Authority	$1.2	2005	Oil
Venezuela	FEM	$0.8	1998	Oil
Vietnam	State Capital Investment Corporation	$0.5	2006	Non-Commodity
Nigeria	Excess Crude Account	$0.5	2004	Oil
Kiribati	Revenue Equalization Reserve Fund	$0.4	1956	Phosphates
Indonesia	Government Investment Unit	$0.3	2006	Non-Commodity
Mauritania	National Fund for Hydrocarbon Reserves	$0.3	2006	Oil & Gas
UAE – Federal	Emirates Investment Authority	n/a	2007	Oil
Oman	Oman Investment Fund	n/a	2006	Oil
UAE – Abu Dhabi	Abu Dhabi Investment Council	n/a	2007	Oil

http://www.swfinstitute.org/fund-rankings/

Total SWF assets are US$4.3 trillion, of which $3.5 trillion are owned by developing and emerging countries. (Source: Sovereign Wealth Fund Institute, see also Table 3, for list of developing and emerging country SWFs and their levels of assets). We assume that a very

small proportion, only 1 per cent, of developing and emerging country SWF assets, equal to US$35 billion are allocated to paid-in capital to expand or create new South-South RDBs. Only paid-in capital is required to be paid in cash for this purpose. If the same conservative ratio of authorized capital to paid-in capital was used as for the CAF (at 2.8) around US$98 billion would be required as authorized capital, but only US$35 billion would be put in as paid-in capital. With this US$35 billion of paid-in capital, (and supposing same ratio of annual loans to paid-in capital as CAF), South-South RDBs could make as much as US$84 billion loans annually.

On the basis of these calculations, (which are somewhat preliminary), the additional annual lending capacity created – of over US$84 billion – would be higher than that of total lending disbursements by the World Bank, the Asian Development Bank, the Inter-American Development Bank, the African Development Bank, and the external lending of EIB (to developing economies) in 2009, the peak year of their lending; in this year, the lending of all these institutions totalled US$64 billion (see again Ocampo and Griffith-Jones et al, op cit). 2009 was the maximum year in history of MDB/RDB lending; due to the global financial crisis, it had significantly expanded over previous averages.

Therefore if a South-South RDB/s had existed in 2009, it could have lent more than all existing MDB/RDBs put together! In normal years, the South-South RDB lending capacity would actually be significantly larger than total current MDB/RDBs lending. This would not only provide very valuable long term funding to developing countries, including LDCs; it could give successful Southern partners the opportunity to influence development strategies in borrowing countries, building on the positive lessons of their development experience. It could give developing borrowing countries not only the opportunity to access far larger external long term resources, but also the opportunity to benefit from learning better the lessons (both positive and negative) of their successful Southern development partners, and, above all, provide an alternative to the more Northern based development model/paradigm that influence existing MDBs/RDBs.

From the perspective of SWFs (and surplus developing country governments), as investors, putting 1 per cent of the total assets of SWFs into a bank that lends long term to other developing countries is not particularly risky. It may actually lower risk. This is because: a) the proportion of total assets is so small, b) risk would be reduced by the clear

benefits of diversification, as growth and capacity to pay in developing countries has very low correlation with that of developed countries, where SWFs have most of their assets invested, c) at least at present, growth rates and prospects for future growth seem much higher in many developing countries (including LDCs) than in developed countries, d) there are important externalities of investing in other developing countries, with which trade and direct investment links are growing rapidly; of course, if this is done at a regional level – with for example South Africa creating a development bank for this purpose in the Southern African region, or expanding its' national development bank for this purpose – joint regional projects, for example in infrastructure can be funded, that would facilitate regional trade directly e) last, but certainly not least, SWFs have long term liabilities (often for future generations), When they invest through private capital markets often these channel funds via very short-term instruments aimed at short-term profits, consistent with private fund managers' incentives, but inconsistent with the aims of SWFs; indeed, this short term management, and the criteria it is linked to, is not optimum, or even appropriate, for institutions with long term liabilities. Creating vehicles like RDBs for long-term lending would give the opportunity to SWFs to match long term assets to long term liabilities.

Clearly more detailed calculations need to be made, as well as discussions held with governments, rating agencies and others to establish requirements for a well rated South-South development bank. One factor to consider would be that new development bank/s may require, for example, a higher capital/loans than calculated above because they do not have accumulated retained earnings, which complement the capital available in institutions like the CAF or other existing development banks; existing banks can leverage their retained earnings as well as their paid-in capital. This may be one important advantage of expanding existing Southern RDBs (where these exist). However, in regions where they do not exist, (e.g. Asia and Africa) a major challenge is to create such new South-South institutions. With time, development banks' retained earnings can become far higher than the paid-in capital, (for the World Bank they are more than double), which would allow future increases in lending, without additional paid-in capital. By creating or expanding RDBs now (at a time when they have very large foreign exchange reserves and SWFs), developing countries would create their own present and future lending capacity, even if in the future they

cannot or do not wish to expand paid-in capital further. That is why the time is now for developing countries to create or expand their own regional or sub-regional banks.

IV Selected aspects of international financial architecture, of relevance for LDCs

The reform of the international financial architecture and the role it can play in LDC development is a broad subject, which escapes the scope of this paper (for a recent discussion of the overall subject by the author, see Griffith-Jones and Ocampo, 2010).

However, we want to highlight a few topics, which are particularly relevant for LDCs, and which can partly be applied to South-South cooperation.

A. Compensatory finance for external shocks

The first of these is compensatory finance in the face of external shocks. There are two reasons why compensatory finance (both through loans and through grants, the latter especially important for LDCs) should increase in importance: 1) External shocks, both linked to natural disasters – many of them caused by climate change– and economic external shocks, caused by international financial crises or sharp fluctuations of commodity prices, are increasing in importance. 2) There is growing evidence that in the past low growth in poor countries is not just caused by a failure of positive growth, but also was caused by the severity and frequency of down turns. Winters et al, 2010 shows that if low income countries (LICs) had halved the percentage of years of negative growth in the period 1960-2007, their average GDP per capita would have increased from 11% to over 70%. A major cause of negative growth years in LICs is the existence of a temporary external shock, for which insufficient finance was available, implying the need for adjustment that could have been avoided were such financing available.

For this reason, the international community should provide compensatory financing to LDCs, that has the following features: 1) it should be of a sufficient scale, to be meaningful in avoiding unnecessary cost of adjustment, 2) it should be granted in a speedy way, so the financing is genuinely counter-cyclical, 3) conditionality should be non-existent or extremely light, for countries pursuing reasonable policies. In this sense, the virtual abolition of low conditionality compensatory financing at the IMF, except for the small RCF, the Rapid Credit Facility, for low-income countries seems a move in the wrong direction; this is in contrast with other-overall positive- reforms at the IMF. Low or zero conditionality is

appropriate for two reasons: a) the economic rationale is to provide finance for compensating for external shocks, that are not caused by domestic policies. So why require that such policies be modified, when they did not cause the problem? b) low or no conditionality facilitates speed of commitment and disbursement of funds, facilitating a counter-cyclical response, and unnecessary/adjustment, which implies development costs. Another separate way of accelerating speed of disbursement is to use triggers, based on forecasts rather than past data; this was for example successfully implemented by the European Commission in V-FLEX, created during the global financial crisis. 4) A final element is that the level of compensatory finance should be related to country needs. Thus, poorer countries (and especially LDCs) should have a higher proportion(ideally total) of their external shock funded than richer developing countries, and a high proportion (if not all) of this funding should be either in the form of grants, or very concessional loans. Similarly countries with other sources of vulnerability, such as high levels of debt overhang, smallness, or frequent natural disasters, such as hurricanes, may need to receive greater compensatory financing; such vulnerability can be measured by indexes, such as the UNCTAD EVI (Economic Vulnerability Index).

A complement to international compensatory financing given or lent by international institutions could be insurance. A major problem of private insurance is its cost. However, South-South inter-governmental mechanisms of insurance could be explored, for example between exporters and importers of a certain commodity, e.g. oil. The following simple deal could be established ex-ante, between an oil exporter and an oil importer[2]. If the price of oil would go above a certain level, the oil exporter would pay the oil importer a certain amount, if the price of oil would go below a particular level, the oil importer would pay the exporter a certain amount. To avoid fees the deal could be carried out through an institution like the World Bank, or a future South-South financial institution. The payment could be either a permanent one or a loan (the latter a sort of liquidity facility).

A similar scheme could be established for other standardized commodities, such as wheat.

Such a scheme would have as main advantage that it would provide greater stability in the current account and therefore in their growth paths to both exporters and importers,

[2] I thank Julie Dane and Avinash Persaud for interesting suggestions on this topic.

protecting them from volatility of commodity prices. Other advantages would be its relative simplicity and practically zero cost.

There could be some problems, which need to be overcome by a good design. One could be that the price of the commodity (e.g. oil) could behave asymmetrically, for example increasing strongly or falling sharply for a long period , this could put a strong burden on either the importer or exporter. This, or other factors, could lead to the other problem; countries who would be doing badly from the deal (e.g. an exporter whose price of the commodity had gone up in the international markets) might be tempted to renege on the deal (arguing for example lack of supply). For this reason, it would be important to have either an IFI (like the World Bank) or a South-South financial institution acting as the intermediary, as this would reduce the chance of countries not respecting the contracts.

B. Counter-cyclical lending instruments; the example of GDP linked lending

As pointed out in the previous section, one of the key problems for LDCs is their vulnerability to external shocks and the very negative impact this can have on their development. It is therefore necessary to build greater resilience against those external shocks. Resilience can be at two levels: a) productive, for example diversification of export structure by products, trading partner countries, etc. b) financial and macro-economic.

Financial and macro-economic resilience is partly, or mainly, domestic. In this sense it implies for example, higher accumulation of foreign exchange reserves. This is in fact something that LDCs have done, to a certain extent, as their foreign exchange reserves have grown very rapidly and consistently from US$12.9 billion in 1999 to US$67.5 billion in 2009; however, as months of imports, the increase is less consistent, and less large, though still important - as they grew from 3.8 months of imports in 1999 to 4.9 months of imports in 2009. (Source: World Bank, Global Development Finance online)

The key point is that the cost of holding foreign exchange reserves is very high, not just in financial terms, but especially in terms of the opportunity cost of foreign exchange resources not used for imports to finance development or increased living standards of the poor.

For this reason, it is valuable to design external counter-cyclical mechanisms that can shelter LDCs, and other developing countries' growth from external shocks. A crucial one is

compensatory financing described above. A second mechanism is loans whose debt servicing varies with some external variable, such as the level of GDP or exports.

One such mechanism that has been widely discussed is GDP linked bonds. The servicing of GDP-linked bonds would be higher in times of rapid growth and lower when growth was slow or negative.

GDP-linked bonds would have important advantages when compared with conventional debt for borrowers and investors, as well as significant externalities for the international financial system. For borrowers, issuing such bonds would help stabilise public spending throughout the cycle as governments would service more debt when they could better afford to, and less in more difficult times. It would also significantly reduce the likelihood of costly and disruptive defaults and debt crises. A temporary reduction of a country's debt service when the economy deteriorates would facilitate more rapid recovery.

For investors, defaults are costly as they result in expensive renegotiation and sometimes in very large losses. As GDP-linked bonds would help reduce the probability of default, effective total payments will tend to be higher than with conventional bonds. Furthermore, GDP-linked bonds would give investors the opportunity of taking a position on a range of countries' growth rates, offering a valuable diversification opportunity. If GDP-linked bonds became widespread across countries, investors could take a position on growth worldwide – the ultimate risk diversification.

For international institutions, there would be benefits from the decreased likelihood of debt crises. Reduced risk of crisis contagion would also benefit other countries. These externalities and the fact that financial innovations are difficult to introduce some initial public action (for example, from the World Bank or from South-South institutions) to help develop this justifies instrument. The World Bank or RDBs, could, for instance, make loans whose servicing would be linked to GDP. The loans could then be grouped, securitised and sold to the financial markets.

The history of financial innovation is essentially one of learning by doing. Inflation-indexed bonds met initial scepticism, relating to problems such as precise measurement of inflation. In fact, once these bonds started to be issued, inflation statistics improved further. Inflation-indexed bonds are now widely accepted across the world; in the UK, they

represent around a quarter of government debt. A similar evolution can be envisaged for GDP-linked bonds.

Introducing GDP-linked bonds would create a market for the economies themselves. The widespread impression that the stock market of a country is a market for the entire economy is mistaken. Stock markets are claims on net corporate profits that can constitute as little as 10 per cent of GDP (See Griffith-Jones and Shiller, 2006)).

GDP-linked bonds could take the form of a conventional bond that pays a coupon tied by a formula to growth rates of GDP, but guarantees a minimum level of debt servicing, even if the economy stops growing.

Whichever way they are created, GDP-linked bonds would have important advantages for different actors. The moment is particularly favourable. Investor appetite for developing countries' risk is strong. The time seems ideal for one of more creditworthy countries to start issuing GDP-linked bonds and for investors to buy them.

The recent experience of countries like Greece, Ireland and Portugal shows that even developed countries would benefit from using such instruments; indeed, the Governor of the Central Bank of Ireland, Patrick Honohan, suggested in a Financial Times article that Irish debt could be transformed into GDP-linked bonds.

In the case of LDCs, this type of counter-cyclical lending should be conceived mainly in the framework of official concessional loans, whether these be made by multilateral or regional development banks, or by bilateral agencies.

It is very encouraging that such counter-cyclical lending to poor countries is already happening, even though at a relatively small scale. Indeed, the Agence Francaise de Development (AFD) has pioneered this approach and made around Euro 200 million of concessional loans to several Sub-Saharan poor countries including to Senegal, Burkina Faso, Mali, Tanzania and Mozambique, starting in 2007[3].

The way these AFD counter-cyclical loans operate is that they have a minimum five year grace period and a floating grace period, also of five years (the alternative loans have a ten year grace period). However, if the country is hit by an external shock (measured in this case by a decline of 5% or more of their exports compared with a previous average), it can

[3] I thank Pierre Jacquet for valuable insights on this subject.

have, if it requests, a debt holiday any time during the duration of the loan – it does not need to service the debt at all that year. There is no conditionality attached to the use of such a payment holiday; from the debtor country perspective this is an important advantage in comparison, for example, to cash equivalent IMF compensatory financing. The total net present value is not affected by this postponement of debt payments. Indeed, if the country does not use the debt service holidays in years five to ten, it gets compensated up to the market remuneration of these repayments (for more details on design, see Cohen, Jaquet et al, 2008).

Like GDP-linked bonds, these AFD counter-cyclical concessional official loans have the advantage of reducing the probability of debt crises and allowing countries to continue growing when hit by external shocks. One possible simple improvement would be to use as trigger for debt repayment holidays the capacity to import, based on terms of trade; this would reflect the fact that many LDCs are hit not only by sharp declines in the prices of their export, but also by sharp increases in the prices of imports, especially of oil and food. Another possible, somewhat more complex amendment, would be to vary the degree of concessionality of loans linked to the terms of trade.

If such counter-cyclical lending was generalized, to other bilateral agencies that do concessional lending and to other MDBs and RDBs, it could play an important role in sheltering LDCs from external shocks. It is positive that the AFD precedent exists and that institutions like the Commonwealth Secretariat are studying the feasibility of its expansion.

From a South-South perspective, this could be a valuable instrument to incorporate into any South-South lending, both bilateral or through regional development banks. In particular, this could be particularly relevant and attractive for Islamic lenders/donors or Islamic development banks. This is because the principle behind GDP-linked bonds and counter-cyclical concessional lending (that debt service payments vary with the economic cycle) seems very consistent with Sharia principles whereby risks of payments are shared between lenders and borrowers, in a way more linked to equity returns,that naturally vary across the economic cycle. It would seem very positive if institutions like UNCTAD could promote such a lending instrument, both in general and in relation to lending by Islamic development banks.

V The domestic financial sector

Though the main topic of this paper is South-South financial links, we will also fairly briefly discuss the domestic financial sector in rather broad terms, as well as its' links with South-South financial cooperation.

In the past, financial sectors in poor countries have often been described – rather dismissingly – as "underdeveloped" or "financially repressed". Whilst there may be some elements of truth in this diagnosis, the relative small size and simplicity of domestic financial sectors in LDCs also has important advantages. Firstly, it means that the financial sector can be shaped by policy-makers in ways that serve the real economy. – financing the needs of credit by companies and ordinary people – whilst financing investment, in the context of a long-term vision of a development strategy, if the State provides one. Secondly, LDC governments have more autonomy to shape and regulate the financial sector, as it is smaller and, therefore, less powerful; indeed, overall LDC governments should be less captured by financial interests, so dominant in developed economies, especially Anglo-Saxon ones. A problem in this regard is the large presence of foreign banks in many LDCs, which weakens the ability of governments to shape the financial sector and regulate it properly. Thirdly, LDC governments can build on the successful experiences of both developing and developed countries of how the financial sector can best serve the real economy; they can also draw negative, but important, lessons from the numerous financial crises, and especially the global financial crisis.

More generally, they can draw the lesson the private banks, particularly if shaped according to the current Anglo-Saxon model, have a tendency towards short-term lending; also in their search for short-term profits, they often prefer funding more speculative activities, and often are unwilling to finance long-term investment in productive projects.

The key challenge is to make "the financial sector a good servant (of the real economy) and not a bad master".

A well functioning financial sector is one which does not have frequent and developmentally costly crises, and, equally important, one that helps finance equitable growth. Significant trade-offs can be encountered here.

To achieve the first objective – financial stability – banking sectors in LDCs need to be tightly regulated and supervised. As the global financial crisis has reminded us, this requires

high capital adequacy requirements, low leverage limits, and fairly tight liquidity requirements, the latter to avoid maturity mismatches. Indeed, many LDC banking sectors are already quite prudently regulated. However, there is consensus that regulation (e.g. of capital requirements) needs further tightening, also partly responding to new international regulatory agreements. However, tight regulation of the private banking sector – good from a financial stability perspective – may discourage further long-term financing by banks, especially to sectors like SMEs, which is essential for creating jobs and for growth. Already it is a source of concern that, for SSA reportedly only 5% of bank loans go to SMEs, whilst they account for an average of 13% of bank loans in other developing countries and regions. SME interest rates are also a third more expensive in SSA than in other developing countries. Tighter regulation could make this worse.

There are of course a number of other market imperfections or gaps in LDC domestic banking sectors, as we discussed in Section II above. These relate to long-term funding for infrastructure, and in new productive capacity including for funding green energy, as well as sufficient finance for SMEs.

To the extent that private banks or other private financial institutions do not meet these financial needs essential for long-term development, these should be funded by new instruments and/or new institutions. In this sense, well run large national public development banks can – as discussed above – play a key role. In several successful middle-income countries, like Brazil, India, China, South Africa and Chile, such development banks have played a very important role in financing investment in key productive sectors, that led both to structural transformation and growth of these economies.

Positive lessons from this experience, and from some LDCs, can be more broadly applied by other LDCs.

Finally, such a diversified (public-private) and development supportive domestic financial sector could interact very constructively with South-South financial links and cooperation. Indeed, MDBs, RDBs (and especially South-South ones) could be more fruitful in their support of LDCs if they worked more closely (via co-financing, or channelling resources through) large and effective national development banks, as well as through a well regulated and stable private financial sector.

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